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DEPARTMENT OF TECHNOLOGY, MANAGEMENT & BUDGET
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March 30, 2012

The Honorable Earl Poleski, Chair
House Appropriations Subcommittee on General Government
N-998 House Office Building
P.O. Box 30014
Lansing, Michigan 48909-7514

The Honorable John Pappageorge, Chair
Senate Appropriations Subcommittee on General Government
S-2 Capitol Building
P.O. Box 30036
Lansing, Michigan 48909-7536

Dear Legislators:

Enclosed is the Report Regarding the Feasibility of Privatizing the Administration of the State Lottery, submitted pursuant to the reporting requirements in Section 822a of Public Act 63 of 2011.

If you have questions regarding the information in the report, please contact Michael Gilliland, Director, DTMB, Financial Services, at (517) 335-3746.

Sincerely,

John E. Nixon, CPA
Director

Enclosure

c: Mary Ann Cleary, Director, House Fiscal Agency
Nancy Duncan, SBO
Michael Gilliland, DTMB
Ellen Jeffries, Director, Senate Fiscal Agency
Matt Sweeney, DTMB

PUBLIC PRIVATE PARTNERSHIP ("PPP") PROGRAM
REPORT

Michigan Lottery – Public and Private Operating Options

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Overview of report

Introduction

Over the past two years, the Michigan Office for Public-Private Partnerships (Office for PPP), within the Department of Treasury (Treasury), and the Michigan State Lottery Bureau (Lottery) have explored at a high level how the operations of the Michigan Lottery could be enhanced through alternative operating structures, including a public corporation and the use of a public-private partnership (PPP) arrangement. In 2010, the Michigan Legislature considered a modernization proposal by the Lottery (introduced as House Bills 6336-6339 and 6341) which would have established a public corporation to operate the Lottery, similar to the Michigan Economic Development Corporation. In 2011, the Office for PPP performed high level research evaluating the potential merits of partnering with the private sector on the Lottery and what may be permissible in light of a U.S. Department of Justice (USDOJ) memo on state conducted lotteries issued in October 2008.¹ Most recently, in Public Act 63 of 2011, the Legislature required the Michigan Department of Technology, Management and Budget (DTMB) to “submit a report regarding the feasibility of privatizing the administration of the state lottery.”

In response to these considerations, DTMB, Treasury, and the Office for PPP engaged KPMG Corporate Finance LLC to help assess public and private options for the Michigan Lottery. The objective of this work is to help the State of Michigan (State) evaluate if public and private options may potentially enhance the performance of the Michigan Lottery, and to outline the relative advantages and disadvantages of the public and private options. This report summarizes the work performed and is intended to help inform the decision on whether to proceed with potential changes in operating structure for the Michigan Lottery. The State will make the decision to proceed with a preferred option. The findings from the tasks described above are reviewed in detail in the following report. The scope of the report included three elements:

- 1) Assessment of the current state of Michigan Lottery;
- 2) Benchmarking Michigan Lottery against a peer group; and
- 3) Identifying public and private options for the Michigan Lottery.

Assessment of the Current State of Michigan Lottery

The first steps in developing this report were to identify the key administrative and legislative requirements in place dictating Lottery operations and to assess the Lottery’s historical performance trends. The Lottery Bureau provided a marketing plan and financial projections that demonstrate the Lottery’s future growth projections and plans to enhance the Lottery’s overall performance. A workshop was held with the Lottery Bureau on October 5, 2011 to identify the Lottery Bureau’s objectives, opportunities for improvements in the Lottery’s operating environment and key issues that should be resolved before any potential procurement for a private partner.

¹Appendix: Scope Of Exemption Under Federal Lottery Statutes For Lotteries Conducted By A State Acting Under The Authority Of State Law (USDOJ Opinion)

Benchmarking Michigan Lottery Against a Peer Group

For benchmarking purposes, the Lottery Bureau and the DTMB identified the following ten relevant peer state lotteries: Georgia, Indiana, Illinois, Massachusetts, New Jersey, Ohio, Oregon, Pennsylvania, West Virginia and Wisconsin. For each of these lotteries, financial reports over the past five years and performance reports were reviewed. Interviews also were conducted with seven of the peer group Lottery directors to gain a better understanding of the current state of those lotteries' operations, legal gambling competition, and economic environment.

Identifying Public and Private Options for the Michigan Lottery

The next stage of the report involved the identification of two private option approaches and a public option that may help enhance the operations of the Michigan Lottery. The research for this portion of the report included assessing relevant domestic and international lottery private management arrangements to identify potential key operating characteristics that Michigan could leverage. Potential high level commercial, financial, payment, and operating structures were outlined and the relative risks/benefits and potential cost savings/increases of each option was assessed. A meeting was held with the legal counsel for the Michigan Lottery Bureau to determine any legislative or legal hurdles or potential impediments and proposed approach. In December 2011, a market sounding was conducted of four potential lottery operators to a) gauge interest, b) provide feedback on potential commercial structure, including the possibility of providing up-front money to the State, and c) identify opportunities for maximizing the net income of the Michigan Lottery.

Michigan Lottery operations

Background

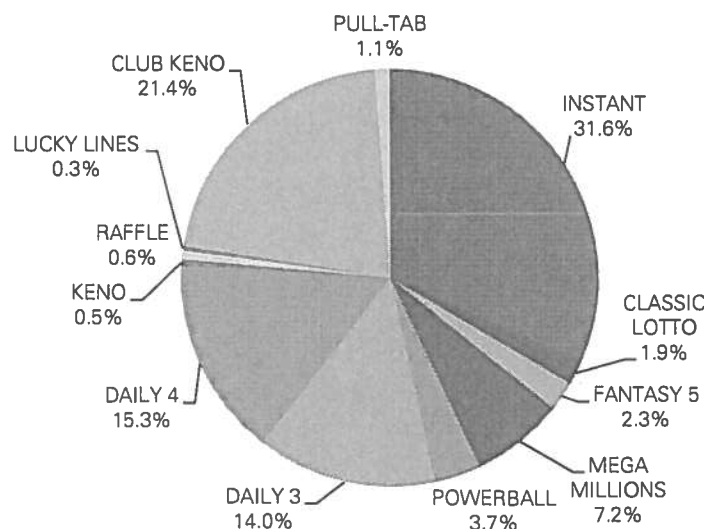
In FY2011, Michigan Lottery's approximate annual revenue was \$2.35 billion, and the Lottery transferred approximately \$727 million to the School Aid Fund to supplement education spending in the State of Michigan. The sale of lottery tickets supports all Lottery expenditures, including prize payments, retailer commissions and operating costs. Since its establishment in 1972, the Lottery has contributed over \$16.6 billion to the School Aid Fund, which supports K-12 education.

The Michigan Department of Treasury's Bureau of State Lottery (Lottery) oversees all lottery operations under the direction of a lottery commissioner appointed by the governor. The mission of the Lottery is the following:

- To maximize net revenues to supplement state education programs.
- To provide fun and entertaining games of chance.
- To operate all games and bureau functions with nothing less than total integrity.

The Lottery operates a number of games that fall into three categories: instant tickets games, online games², and club games. As of January 2012, Michigan offered more than 77 games. The games offered were priced between \$1 and \$20 and top prizes ranged from \$1 to \$2 million dollars. Online games offered were Mega Millions, Powerball, Classic Lotto 47, Fantasy 5, Daily 3, Daily 4, Keno, Raffle, Lucky Lines and Club Keno. Club games include Club Keno, Club Keno Kicker, Pull Tabs, and The Jack. Club games continue to be a significant contributor of total sales for Lottery since introduction in 2003. The chart below shows the distribution of games offered by the Michigan Lottery:

Chart 1: Michigan Lottery Game Mix FY 2011



Source: Michigan Lottery Comprehensive Annual Financial Report, Fiscal Year 2011

² Online gaming is the term used by state lotteries for the games provided by a network of lottery computer terminals linked to a central computer that tracks the lottery activity. This term is not to be confused with Internet gaming or I-gaming, which means lottery games available on the Internet.

The Michigan Lottery operates in a competitive gaming environment. The State of Michigan has 19 casinos owned by Native American tribes³ and three licensed commercial casinos in the City of Detroit. Most of the casinos on Native American reservations opened in the 1980s and 1990s, but several casinos have opened in the past few years and new casinos may open in the future. The three licensed casinos in Detroit were authorized by the State in 1997. The Michigan Gaming Control Board licenses and regulates the commercial casinos in Detroit and their suppliers and employees and oversees the Native American casinos in Michigan.

Governance and operating structure

In May 1972, Michigan voters approved a constitutional amendment proposed by the General Assembly, which authorized the State to conduct a lottery. In response, Governor William Milliken signed into law the McCauley-Traxler-Law-Bowman-McNeely Lottery Act 239 on August 1, 1972 (Lottery Act) establishing a state lottery in Michigan:

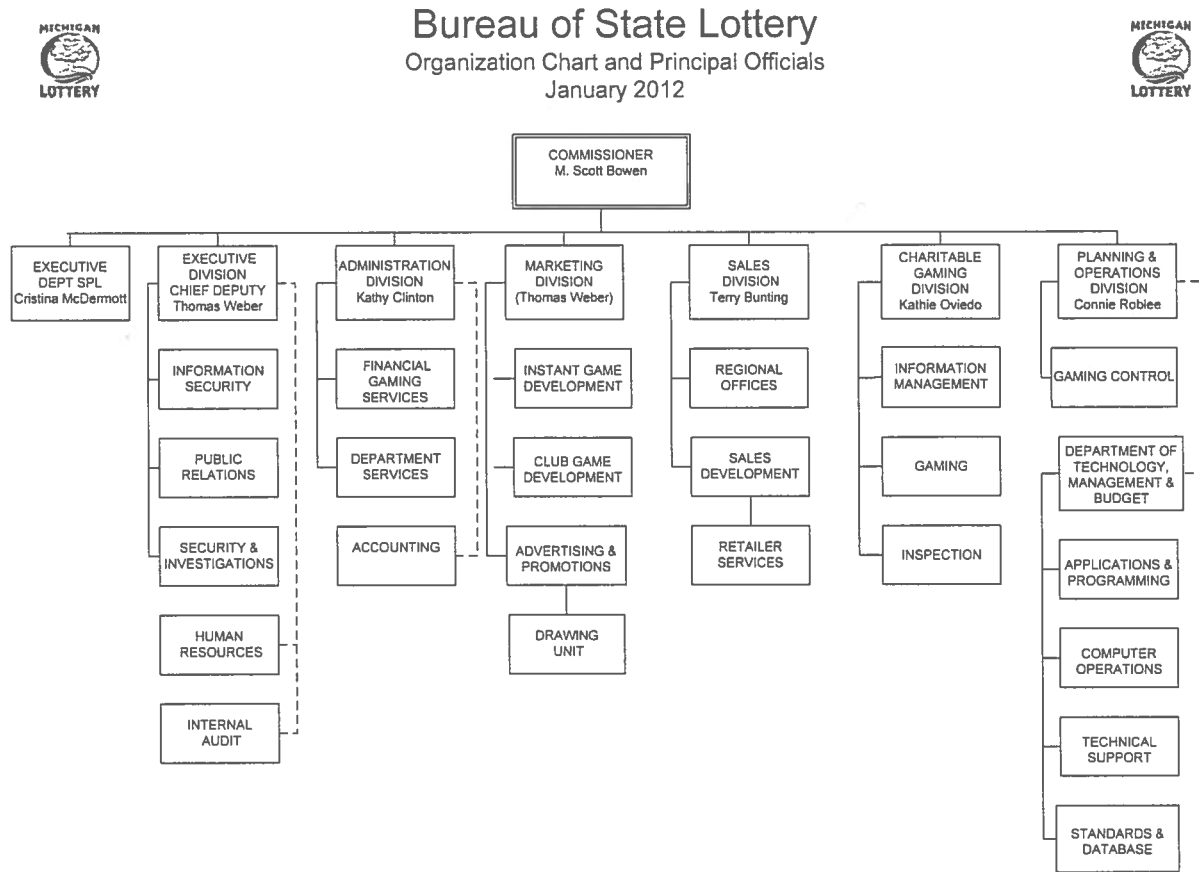
"AN ACT to establish and operate a state lottery and to allow state participation in certain lottery-related joint enterprises with other sovereignties; to create a bureau of state lottery and to prescribe its powers and duties; to prescribe certain powers and duties of other state departments and agencies; to license and regulate certain sales agents; to create the state lottery fund; to provide for the distribution of lottery revenues and earnings for certain purposes; to provide for an appropriation; and to provide for remedies and penalties."

According to the Lottery Act, the head of the Lottery is the commissioner, who is appointed by the governor and is responsible for policy-setting and day-to-day operations of the Lottery. The commissioner may delegate primary operational oversight duties to the respective deputy commissioner of specific divisions within the Lottery.

The Lottery includes the following divisions: Executive, Administrative, Marketing, Sales, Charitable Gaming, Planning and Operations. The Lottery also operates regional sales offices which recruit, train, and provide support for Lottery retailers and provide customer service such as claiming and validation for winning tickets. As of January 2011, Lottery employed 174 full-time equivalent (FTE) employees. Figure 2 below is a high-level organizational chart of the Lottery.

³ http://www.michigan.gov/documents/mgcb/What_are_Tribal_casinos_340795_7.htm

Figure 2: Organizational Chart



Revised:1/11/12

Source: Michigan Lottery

The Lottery works with DTMB and the Legislature to develop an annual budget for the administrative costs of the Lottery. The proposed budget is approved by the Legislature annually. Revenues from ticket sales support all Lottery costs, and the approved budget becomes a spending cap for administrative expenses, including advertising. The Lottery also prepares revenue and expenditures forecasts that are compared to actual revenue and expenses throughout the year.

The Lottery contracts out a number of services, including operation of online gaming, instant ticket printing and advertising. GTECH Corporation, a subsidiary of Lottomatica Group, is the Lottery's largest vendor and operates the Lottery's online gaming systems, including its enterprise software, IP-telecommunications network and an estimated 11,000 terminals throughout the State. GTECH also provides maintenance of the central system, terminals, communications network, field service, retailer training and marketing support.

Performance

In FY 2011, total Lottery revenue reached \$2.35 billion, a decrease of \$23 million, or about 1%, compared to FY 2010. The Lottery's FY2011 expenditures of \$1.6 billion consisted primarily of prize payouts, retailer and vendor commissions, and operating expenses.⁴ Net income is transferred to the State for the School Aid Fund, General Fund and Community Health Fund. In FY 2010, total transfers to the State were \$713.6 million of which \$701.3 million was contributed to the School Aid Fund. In FY 2011, total transfers increased to \$737.6 million of which \$727.3 was contributed to the School Aid Fund. This represents an increase of about 3.4% in total transfers to the State from FY 2010 to FY2011. The Lottery's compound annual growth rate for the past five years is 1.35%. The Lottery's net income dipped in FY 2008 and FY2009 coinciding with the economic downturn, and, although net income has grown the past two years, it has not yet returned to the pre-recession level of \$752.9 million. The chart below shows the change in Lottery net income from FY 2005 to FY 2011.

Chart 3: Michigan Lottery Gross Operating Revenues and Net Operating Income (FY05 to FY11)

Fiscal Years	Gross Operating Revenues	Net Operating Income
FY 2005	2,090,132,247	675,210,211
FY 2006	2,232,204,317	693,382,134
FY 2007	2,363,001,293	752,878,438
FY 2008	2,351,081,801	745,185,959
FY 2009	2,398,994,649	706,685,256
FY 2010	2,379,974,863	718,209,813
FY 2011	2,357,416,514	741,390,695

Source: Michigan Lottery Comprehensive Annual Financial Reports, Fiscal Years 2005 - 2011

Planned growth

The Lottery develops annual financial projections prior to the start of each fiscal year. For FY2012, the Lottery projects that total sales will increase by 2.65 percent and transfers to the school aid fund will increase by 0.76 percent compared to FY2011. The Lottery's financial projections are based on a comprehensive marketing plan that the Lottery publishes on a yearly basis. The Lottery does not develop multi-year financial projections.

The Lottery's FY 2012 marketing plan for online and instant games evaluates game prize structures, price points, number of tickets, launch schedules and ticket mixes. The FY 2012 plan to expand Lottery growth focuses on:

⁴ Operating expense includes salaries, wages and benefits; other professional services; printing and supplies; other general and administrative; and promotion and advertising

- Retailer Recruitment and Strategy – Continuing retailer recruitment efforts and promoting effective strategies to enhance sales.
- Sales Distribution – Exploring Internet gaming and expanding Club Games and use of “To Go” – the first multi-channel game experience which can be played on the web or through mobile phones.
- Marketing Channel – Building a stronger presence and reaching consumers through different interactive devices such as the web, email and mobile devices.
- Product Development – Rolling out new game designs, jackpot sizes, and price points.

Lottery officials indicate revenues are highly dependent on many factors, including demographic characteristics of the State, game mix, advertising, and economic conditions. Michigan’s product plan accounts for many of these factors including a relatively recent smoking ban enactment and the Gun Lake Casino opening in 2011.

Additionally, in December 2011 the USDOJ issued an opinion paving the way for states to provide lottery games over the internet. Lottery’s FY2012 projections did not account for Internet gaming. At the time of this report writing, the consequences of the USDOJ memo to the Michigan Lottery was not yet clear, although Lottery officials were preparing in advance of such an opinion and had explored the concept of Internet gaming in their marketing plan. Lottery officials are in the process of evaluating how games currently offered may be distributed over the internet.

Key legislation and administrative considerations

This section discusses key laws and regulations that have a significant impact on the management and operations of the Lottery. The table below summarizes relevant laws and regulations. Any action by the State with respect to the Lottery’s operating and/or governance structure should be carefully considered by appropriate legal counsel in light of these and any other relevant acts.

Table 1: Relevant Laws and Regulations

Government	Laws Impacting Management Structure	Laws Impacting Operations
Federal	<ul style="list-style-type: none"> ■ Federal lottery laws on state-conducted lotteries, as interpreted in a 2008 USDOJ memo 	<ul style="list-style-type: none"> ■ 1961 Federal Wire Act ■ USDOJ memo on Internet gaming, issued December 2011
State	<ul style="list-style-type: none"> ■ Michigan State Constitution § 41. ■ Michigan Lottery Act 	<ul style="list-style-type: none"> ■ Michigan State Constitution § 41. ■ Michigan Lottery Act

Key Laws Impacting Management Structure

Federal: In response to many states’ interest in private operation and monetization of their lotteries, the USDOJ issued a memorandum opinion on federal lottery laws. The October 16, 2008 USDOJ opinion stated the following:

“We conclude that the statutory exemption for lotteries “conducted by a State” requires that the State exercise actual control over all significant business decisions made by the lottery enterprise and retain all but a de minimis share of the equity interest in the profits and losses of the business, as well as the rights to the trademarks and other unique intellectual property or essential assets of the State’s lottery. It is permissible under the exemption for

a State to contract with private firms to provide goods and services necessary to enable the State to conduct its lottery, including management services, as discussed herein."

While federal law does allow a state to contract with a private firm to "provide goods and services necessary to enable the state to conduct its lottery, including management services," such a company cannot receive more than a "de minimis share" in the profits and losses of a state-run lottery. USDOJ did not provide a definition of "de minimis share" but footnote 9 in the USDO memo provides examples of rules where 5% ownership interest was considered de minimis. The practical result of this ruling is that states (including California, Indiana, and Illinois) that had considered private management agreements and public-private partnerships with sizable net present value monetization of future lottery proceeds for an extended period of time (up to 99 years in some cases) could not proceed with such transactions.

State: A 2004 amendment to the State Constitution of Michigan (§ 41 Lotteries) also may impact a potential new management structure for the Lottery. As a result of the amendment, the State constitution now requires a statewide referendum to approve any law that "authorizes any form of gambling." The Michigan Attorney General's office noted that a new operating structure, such as a public corporation or private management contract, may be interpreted as a new form of gambling; however, further legal analysis will be required to confirm whether either structure would represent a new form of gambling. If this legal analysis does determine that a change in operating structure does indeed constitute a new form of gambling, a law authorizing such a structure may require "the approval of a majority of electors voting in a statewide general election and a majority of electors voting in the township or city where gambling will take place."

Key Laws Impacting Operations of Lottery

Federal: Until recently, the federal Wire Act prevented states from providing lottery games on the Internet. However, on December 23, 2011, the USDOJ released a memorandum responding to inquiries from two state lotteries and two U.S. Senators about whether the Wire Act (18 U.S.C. § 1084) applies to intrastate sales of lottery tickets on the Internet. The USDOJ memo indicates that the Wire Act does not apply to non-sports betting, which means that for the first time, states can provide lottery games over the Internet and partner with each other for interstate gaming. As described above, the impact of this memo on the Lottery was not clear at the time of this report's writing.

State: The Michigan Lottery Act, which established the Lottery, also has an impact on lottery operations. Since July 11, 1988, the Lottery Act has included a clause which allows the winner of a prize greater than \$10,000 to remain anonymous, though Mega Millions and Powerball winners are exempt from this clause. According to Lottery management, this impacts Lottery's ability to generate publicity and advertise prizes won. The majority of lottery jurisdictions do not have restrictive anonymity requirements. Of the 27 lotteries surveyed by the Lottery management, only six besides Michigan offer their players an anonymity option. Additionally, the Lottery Act has restricted the prize payout amount to 45% of total revenue, a restriction which has been temporarily lifted several times. However, in 2011, the Michigan Legislature passed legislation to remove this restriction on the Lottery. The Lottery's current prize payout is in the upper 50 percentile and Lottery management expressed concerns that a lower mandatory payout would have had an adverse impact on growing lottery operations.

Benchmarking performance

43 states and the District of Columbia currently operate lotteries in the United States. Michigan ranks in the top ten among states that operate lotteries in terms of sales, prize payout and net income transferred to the state (see Table 2).⁵ Differences in sales among states depend on the games offered, as well as state regulations, marketing and advertisement strategies and limitations, administrative costs, external competition, demographics, and regional attributes. States that offer video lottery terminals (VLTs) also typically have high sales, because VLTs offer very high prize payouts and generate significant revenue.

Table 2: Top Ten U.S. Lotteries for Total Sales, Prizes & Transfers (\$m)

Rank	Lottery	Population (M)	Traditional Sales*	VLT	Total Prizes**	Transfer to State
1	New York***	19.58	6,781.07	1,037.25	3,952.01	2,666.38
2	Florida	18.68	3,900.50		2,346.16	1,246.79
3	California	37.23	3,040.96		1,611.37	1,072.50
4	Texas	25.21	3,738.37		2,300.18	1,063.09
5	New Jersey	8.73	2,605.10		1,511.91	924.01
6	Pennsylvania	12.63	3,065.72		1,867.08	915.74
7	Massachusetts	6.63	4,412.09		3,174.89	903.48
8	Georgia	9.91	3,387.42		2,129.14	883.88
9	Ohio	11.53	2,490.19		1,513.72	728.63
10	Michigan	9.93	2,359.23		1,381.63	713.68

* This data represents only revenue from traditional lottery games

** Prizes do not include VLT prizes paid

*** Combined government revenues from traditional sales and VLT operations

Source: 19th Edition, La Fleur's 2011 World Lottery Almanac (The 2011 Almanac contains FY2010 data. The 2012 Almanac was not available at the time of this report's development.)

Michigan Lottery's performance was benchmarked against peer states to gain a further understanding of current performance and future growth opportunities. The following ten states were identified by the Lottery as peers or aspirants for benchmarking: Georgia, Illinois, Indiana, Massachusetts, New Jersey, Ohio, Oregon, Pennsylvania, West Virginia and Wisconsin.

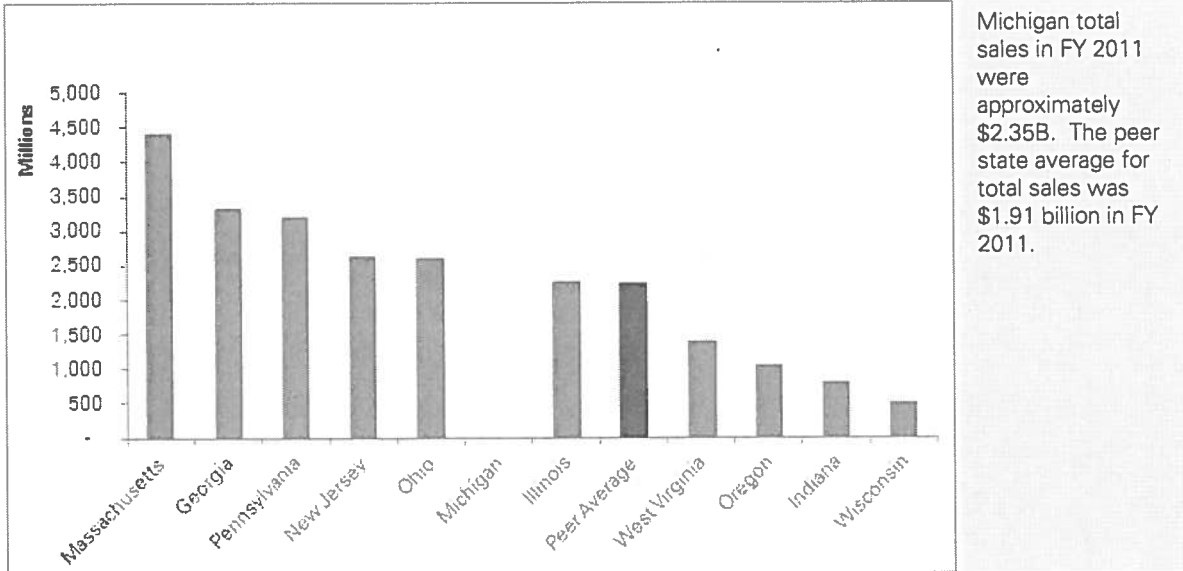
Key aspects of lottery operations and performance were researched including:

- Total sales
- Net income
- Games sales and product mix
- Prize payout
- Retail distribution
- Advertising

⁵ See Appendix: U.S. Lottery Rankings

In FY 2011, Michigan Lottery ranked sixth among peer states for total sales and sales per capita. Chart 3 and Table 3 below compare Michigan's sales performance to peer states and to the peer state average.

Chart 3: Total Sales for Peer States, FY 2011 (\$m)



Source: State Lotteries' Comprehensive Annual Financial Reports, Fiscal Year 2011

Table 3: Sales per Capita and Net Income per Capita for Peer States, FY 2011 (\$m)

States	Rank	Sales per Capita FY2011 (\$m)	States	Rank	Net Income per Capita FY2011 (\$m)
West Virginia	1	750	West Virginia	1	315
Massachusetts	2	672	Massachusetts	2	135
Georgia	3	340	New Jersey	3	101
New Jersey	4	299	Georgia	4	86
Pennsylvania	5	252	Pennsylvania	5	75
Michigan	6	239	Michigan	6	75
Ohio	7	225	Ohio	7	63
Oregon	8	225	Oregon	8	63
Illinois	9	176	Illinois	9	52
Indiana	10	121	Indiana	10	36
Wisconsin	11	88	Wisconsin	11	25

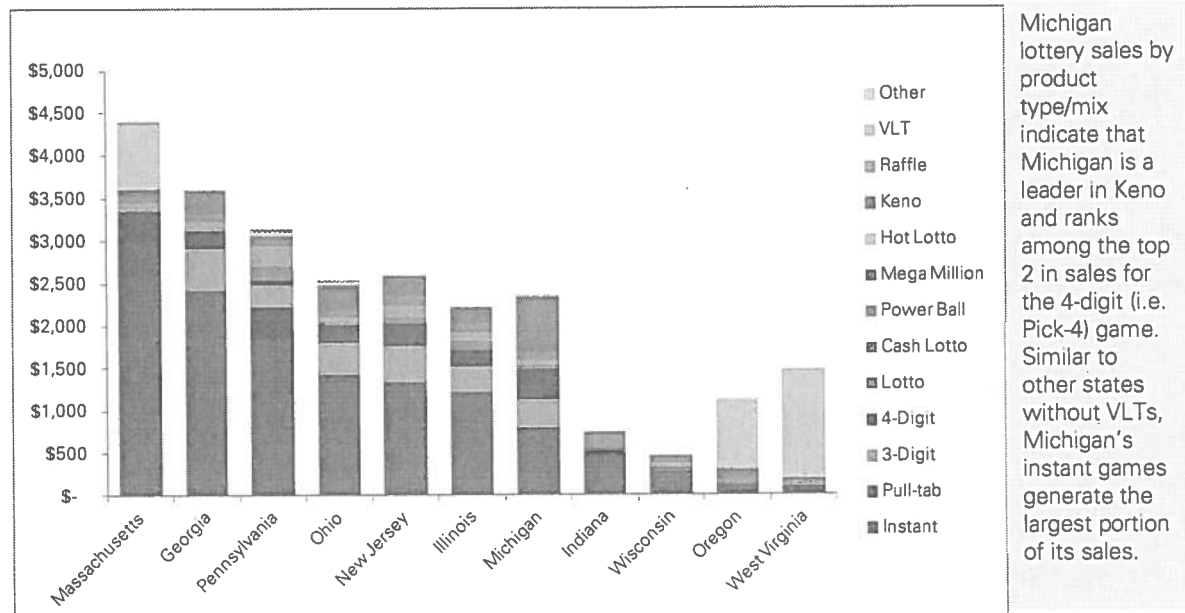
Michigan FY 2011 sales per capita were approximately \$239M and net income per capita was approximately \$75M. Michigan ranked sixth (6th) among peer states. (Note: Sales from VLT included.)

Source: State Lotteries' Comprehensive Annual Financial Reports, Fiscal Year 2011

Lottery products can be classified into instant games, online games and VLTs. Instant games typically make up the largest portion of lottery sales. VLTs were pioneered by South Dakota in 1989 and are considered the newest class of game in the field of state lotteries. Only a handful of states today operate VLTs for a variety of reasons, including concerns about expansion and appropriateness of gambling. VLT games offer higher odds and the opportunity for

instantaneous reinvestment of winnings and higher prize payouts than traditional scratch games.⁶ Of the peer state lotteries examined, only the Oregon and West Virginia lotteries offer VLTs. Chart 4 below illustrates the combination of games provided by peer states.

Chart 4: Lottery Sales by Game Mix for Peer States



Source: 19th Edition, La Fleur's 2011 World Lottery Almanac (The 2011 Almanac contains FY2010 data. The 2012 Almanac was not available at the time of this report's development.)

One of the key factors in growing sales of lottery tickets is increasing the player's ability to win. Prize payout – the percent of sales that is returned to the player as prize – helps to predict returns to the player and higher prize payouts tend to increase sales. With instant games, most lotteries pay back between 55 percent and 65 percent of sales as prizes. The typical prize payout is 50 percent for online games and up to 89 percent for VLTs. Michigan's prize payout average for all games is 58 percent and Michigan Lottery ranks seventh largest in prize payout percentage for all lottery products (see Table 4 below).

⁶ 19th Edition, La Fleur's 2011 World Lottery Almanac

Table 4: Average Prize Payout for Peer States, FY2011

State	Average Prize Payout (% of sales)	Average Per Capita Sales (\$)
Massachusetts	72%	693
Georgia	63%	342
Indiana	60%	122
Ohio	60%	207
Pennsylvania	60%	246
Illinois	59%	164
Michigan	58%	236
New Jersey	58%	287
Wisconsin	57%	87
Peer Average	52%	321
Oregon	20%	296
West Virginia	8%	801

Source: State lotteries' comprehensive annual financial reports for FY 2011

Note: Average prize payout for Oregon and West Virginia are not inclusive of VLT

Michigan Lottery had an advertising budget of \$18,620,00, or about 0.79 percent of sales in FY 2010 as indicated in Table 5 . Peer states had advertising budgets as a percentage of sales ranging from 3.3 percent for West Virginia Lottery to 0.05 percent for Massachusetts Lottery. The peer average is approximately 1.33 percent. Michigan's advertising budget as a percentage of sales ranked 8 out of 10 peer states, about 40 percent lower than the peer average for percentage of sales budgeted for advertising (see Table 5 below).

Table 5: Advertising Budget Per Capita and as a Percentage of Sales for Peer States

States	Advertising		
	Budget (\$)	Advertising per Capita (\$)	Percentage of Sales (%)
West Virginia	\$ 6,080,000	\$ 3.28	3.30%
Oregon	\$ 9,000,000	\$ 2.34	2.82%
Wisconsin	\$ 7,470,000	\$ 1.31	1.55%
Indiana	\$ 10,950,000	\$ 1.68	1.44%
Peer Average	\$ 15,284,000	\$ 1.91	1.33%
Pennsylvania	\$ 38,990,000	\$ 3.08	1.25%
Illinois	\$ 23,550,000	\$ 1.83	1.06%
Ohio	\$ 22,370,000	\$ 1.94	0.88%
Michigan	\$ 18,620,000	\$ 1.89	0.79%
Georgia	\$ 25,230,000	\$ 2.60	0.70%
New Jersey	\$ 7,200,000	\$ 0.82	0.28%
Massachusetts	\$ 2,000,000	\$ 0.31	0.05%

Source: 19th Edition, La Fleur's 2011 World Lottery Almanac (The 2011 Almanac contains FY2010 data. The 2012 Almanac was not available at the time of this report's development.)

Lotteries license retail businesses to sell lottery tickets. Among peer states, Michigan has the most retailers and ranks 6th in terms of highest sales per retailer (as shown below in Table 6). In FY 2010, a majority of the lottery ticket

sales in Michigan occurred at gas stations/convenience stores (28 percent of sales), followed by liquor stores and restaurants and bars, which were responsible for 25 and 20 percent of ticket sales, respectively.⁷

Table 6: Sales per Retailer for Peer States (\$)

States	Retailer		
	Number of Retailers	Residents per Retailer	Sales per Retailer (\$)
Massachusetts	8,071	812	\$ 544,852
New Jersey	6,236	1411	\$ 415,475
Pennsylvania	8,520	1487	\$ 367,265
Illinois	7,546	1702	\$ 293,732
Ohio	10,091	1143	\$ 251,620
Peer Average	5,386	1185	\$ 238,967
Michigan	10,797	915	\$ 218,551
Indiana	3,921	1662	\$ 193,497
Wisconsin	3,632	1567	\$ 132,709
West Virginia	1,596	1162	\$ 115,476
Oregon	4,248	904	\$ 75,047
Georgia	N/A	N/A	N/A

Source: 19th Edition, La Fleur's 2011 World Lottery Almanac (The 2011 Almanac contains FY2010 data. The 2012 Almanac was not available at the time of this report's development.)

Michigan's net income compound annual growth rate (CAGR) for the five year period from FY 2006 to FY2011 was 1.35 percent, above the average for the peer group of negative 0.1percent (see Table 7 below). Peer states have a net income CAGR ranging from negative 3.43 percent to 2.61 percent. The small growth range among states may reflect economic trends, diminishing brand value or maturity of products.⁸

⁷ 19th Edition, La Fleur's 2011 World Lottery Almanac

⁸ Frost and Sullivan, US Lotteries Achieving Strong Results in a Weak Economy

Table 7: 5-year Compound Annual Growth Rates for Peer States, FY2006 to FY2011

State	5-year Average Net Income (\$m)	5-year CAGR (%)
Ohio	\$689	2.61%
Illinois	\$629	2.34%
New Jersey	\$839	2.07%
Michigan	\$726	1.35%
Indiana	\$205	1.17%
Georgia	\$854	0.74%
Peer Average	\$644	0.51%
Pennsylvania	\$928	0.40%
Wisconsin	\$141	-0.83%
Massachusetts	\$901	-1.37%
West Virginia	\$627	-1.45%
Oregon	\$542	-1.46%

Source: State lotteries' comprehensive annual financial reports for FY 2011

Overview of operating structures in peer states

This section of the report describes the operating structures of the peer state lotteries identified for benchmarking to the Michigan Lottery. The benchmarking process included interviews with the directors of seven of the peer lotteries. Through this review, four overarching operating structures were identified:

- Direct and comprehensive public control
- Traditional state agency with significant outsourcing
- Public corporation
- Private management agreement

Direct and comprehensive public control

Direct and comprehensive public control is best represented by the Massachusetts and West Virginia lottery operations. Both states operate their primary games and Massachusetts operates all games internally. As state agencies, the West Virginia Lottery and the Massachusetts Lottery are governed by state requirements for purchasing and personnel with related rules and regulations. West Virginia operates its own central system for Video Lottery Terminals (VLTs), which account for approximately 85% of lottery sales in West Virginia. Massachusetts Lottery operates its own instant games systems, which account for approximately 70% of sales, as well as all of its other lottery games. In comparison, most states contract out the operations of their gaming systems. In both Massachusetts and West Virginia, a vendor provides only the gaming technology and the state lottery maintains and manages the gaming equipment. This provides both lotteries with direct control and complete information on all game operations.

Traditional state agency with significant service related contracting

Among the peer lotteries, the lotteries in Michigan, Wisconsin, Ohio, New Jersey, and Oregon are operated by state agencies. All of these lotteries contract out major functions, including gaming operations, marketing research and support, instant tickets games, and advertising. As state agencies, they must abide by state procurement, personnel, disclosure of public records, civil service, appropriations and related rules and laws. Typically, state agencies need legislative approval to advertise and award large contracts, must compensate employees based on pre-determined

civil service salary schedules and must receive an appropriation from the Legislature for any spending (including from lottery game revenues).

In interviews, a common theme emerged that traditional government guidelines regarding budgeting, personnel, and procurement restrict ability to procure quickly, make staffing decisions, provide market level compensation, and manage budgets. In addition, some state lotteries have legislative restrictions on aspects of their operations such as the type or quantity of lottery advertisements. For example, Wisconsin has a prohibition in the state constitution on “promotional advertising” for the lottery. Michigan is budgetarily confined to spending an annual established budget on advertising. Michigan’s advertising budget in FY2011 was the same as its advertising budget in 1998.

Public corporations

Among the Michigan Lottery’s peers, the Hoosier Lottery in Indiana and the Georgia Lottery Corporation represent the quasi-public corporation operating model. These lotteries are legislatively enabled to operate like entrepreneurial enterprises. Since the Hoosier Lottery and the Georgia Lottery Corporation are public corporations authorized to act independently of the state, they may establish their own procurement, personnel, civil service and appropriation rules. Similar to many traditional state lotteries, the Hoosier Lottery and the Georgia Lottery Corporation contract out operating functions, such as online gaming system, marketing research and support, instant ticket games and advertising.

The Georgia Lottery is directly overseen by a seven member board of directors appointed by the governor. The board of directors responsibilities include:

- Appointing the Georgia Lottery Corporation Chief Executive Officer (CEO)
- Approving the annual budget recommended by the CEO
- Approving the terms of major lottery procurements recommended by the CEO
- Adopting regulations, policies, and procedures relating to the conduct of lottery games, including types of games, sale price, number/amount of prizes, manner of payment, etc.

This structure is not entirely independent of the state or lawmakers, as recently evidenced by the Georgia Legislature passing a law (HB 326) in May 2011 that amended the Georgia Lottery Corporation establishment act by limiting the Georgia Lottery Corporation’s ability to provide bonuses to sales staff and management based on performance.

Private Management Agreement

To date, there is only one example of a state lottery private management agreement in the U.S.. In January 2011, the Illinois Lottery signed a private management agreement with Northstar Lottery Group for two five-year terms. This private management agreement compensates the private manager primarily through monthly payments for services along with de minimis revenue sharing as a performance incentive. In addition, the state has retained control over all significant business decisions, including the ability to countermand the decisions of the private manager.

The following are key provisions of the Illinois Lottery Private Management Agreement with Northstar Lottery Group:

- State retains control to countermand or direct manager’s operating decisions.
- State retains ownership of Lottery assets including intellectual property.
- Northstar will earn a yearly management fee for its personnel costs and other overhead expenses.
- Northstar is also compensated by the Illinois Lottery on an annualized basis for all operating costs approved by the state, including supplier fees.
- Northstar is required to maintain a \$100 million performance bond

- Northstar will receive incentive compensation annually up to 5 percent of the actual net income earned by the state if the actual net income exceeds the base net income levels for each year set by the state and published during the procurement.
- Northstar must make shortfall payments up to 5 percent of the actual net income earned by the state if it misses the base level net income established by Illinois Lottery and the minimum profit level Northstar guaranteed for each of the first five years of the agreement.
- Termination for convenience allows state to terminate if net income shortfalls are more than 10% for any 2 consecutive years, or 3 out of 5 years.

Market sounding

Outreach process

As part of the review of public and private options available to the Michigan Lottery, a market sounding was conducted with four lottery operators who potentially could enter into a private management agreement with the State to operate the Lottery. The objectives of the market sounding were to gauge private sector interest in a management contract to administer the Lottery, obtain feedback from the private sector on potential commercial structures and identify opportunities for enhancing Michigan Lottery's operations.

The following protocol was followed for the market outreach:

- A review by the Michigan State Bureau of Lottery of the market participants and discussion items.
- In-person meetings with each company to discuss questions and solicit feedback.
- Standard information was presented to all the companies providing background information, intent of this study, and objectives of the market outreach.
- Each participant was given 90 minutes for the meeting.

The four firms that participated in the market sounding meetings were GTECH, Scientific Games, Camelot and Intralot. Each of the firms was asked for their input on the following discussion items:

- Comment on the current state and federal legal constraints and their impact on a potential private manager's business plan (see Michigan State Constitution §41. Lottery and Lottery Act 239 of 1972).
- Provide input on key considerations for a potential private Lottery management contract.
- Discuss private management structures for Lottery, including potential compensation and/or potential revenue sharing mechanism.
- Provide input related to the optimal level and nature of State oversight of a potential private Lottery manager.
- Please comment on who should/could most effectively manage risk such as revenue, operating costs, human resource/personnel, technology, game innovation, distribution etc.
- Describe the key benefits to a private management operation of the Lottery.
- Discuss the key constraints that exist within Michigan vis-à-vis a private management contract.
- Provide input to the potential commercial structures.

Observations and key takeaways

In order to help preserve unfettered feedback and honest dialogue, the four participants were assured that individual statements would be held in confidence; however, the participants were notified that a summary of the common themes would be documented in this report. The four firms that participated in the market sounding expressed differing views on many of the discussion topics, and no clear consensus emerged. The key takeaways described

below should be considered in the context of a market sounding which naturally reflects the self-interest of participants.

Key Benefits to a Private Management Contract

Some of the firms stated that a private manager could increase the net income of the Michigan Lottery if given sufficient freedom to operate as a business. These firms claimed that the private sector could potentially introduce a number of improvements in areas such as data and analytics, empirical approaches to retailer distribution, technology, branding and better management of vendors. Other firms claimed that similar growth could be achieved by the Michigan State Lottery Bureau, especially if it was converted into a public corporation and could operate with greater flexibility. These firms stated that the areas of likely growth for Michigan Lottery, including instant games and Internet gaming, could be achieved by the Lottery as well as by a private manager if independence and day-to-day management included the ability to determine personnel, procurement, and operational policies independently.

Optimal Payment Mechanism

The firms had differing opinions on the optimal payment mechanism. Some expressed a preference for an upfront payment by the private manager to the State, which they stated would avoid ongoing potential conflict over payment terms. Those firms also stated that an upfront payment to the State for the authority to operate its lottery would be allowable under federal lottery laws, including the 2008 USDOJ opinion, if the payment was a performance bond or otherwise accounted for operating costs and a de minimis percentage of future net income. Others stated that ongoing payments, including a small percentage of net income, would keep the State and private manager more fully engaged in the success of the lottery over time. Several firms noted that tying compensation to net income would better align the incentives of the private manager and the State, compared to the gross revenue based compensation that is currently included in many lottery vendor contracts.

Impact of State Legal Constraints

In terms of the impact of state legal constraints on a potential private manager's business plan, the firms' views also differed. A key legal constraint identified was the Michigan State Constitution (§ 41 Lotteries) which requires statewide and local referendums for any law authorizing a form of gambling in Michigan and for any new lottery game using table games or player operated mechanical or electronic devices. Some firms noted that they would need further clarity on the legal implications for the private manager's ability to innovate. However, some of the firms stated that this constitutional provision would not deter them from bidding if the Michigan Lottery decided to seek a private manager and that they would factor any restrictions on new games into their business plans.

Key Considerations for a Private Management Agreement

All of the firms referred to the private management agreement finalized in January 2011 between the Illinois Lottery and Northstar Lottery Group as an example of key considerations for a private agreement, but the firms disagreed over whether the Illinois agreement has been optimally structured. Some firms noted that the Illinois agreement allows the state to approve or disapprove of the manager's contractors, retailers, and game selection, and the agreement requires large procurements be approved by the Illinois Legislature. These firms stated that they believed a private management agreement would work best if the state's oversight role did not include day-to-day management activities and operational risk transferred to the private manager. However, other firms claimed that the Illinois agreement strikes the right balance for risk allocation.

Legal Gambling Competition

Some of the firms noted that a consideration in bidding for a private management contract in Michigan would be the competition from legal gaming and the potential for increased legal gaming. They asked how a state would protect the private sector from the possibility of more casinos opening, including whether or not compensation events would be available. However, other firms stated that they viewed the Michigan Lottery, including the competitive environment in the state, as a known quantity that they would be comfortable bidding on in a private management competition.

Public and private operating structures

Risk allocation

In considering the public and private operating options for the Lottery, the first step was to identify the potential risks associated with lottery operations. In traditional public sector operations, the majority of risks are retained by the public sector. For example, the Lottery retains revenue risk; therefore, if its annual net income decreases, the state receives a smaller transfer. Under private operation, the private sector is expected to assume substantial risks. The optimal arrangement is one where risks are allocated to the party best suited to manage them and meets the policy goals of the public authority – an arrangement that ideally creates value for both the public and private partners.

In conjunction with Lottery management, 18 categories of risks were identified related to Lottery management and operations. These risks and their potential allocation to the State, to a public corporation or to a private entity were discussed with Lottery and DTMB management. This risk allocation provided a framework for the development of the public and private operating structures, which are described in the next section of the report. Below is a high-level assessment of each of the categories of risk.

Risk Categories	Overview and Risk Allocation
<ul style="list-style-type: none"> ■ Ownership ■ Oversight and Control 	<p>All lotteries in the U.S. are owned, overseen and controlled by states or by public corporations authorized and controlled by states. Per the USDOJ's interpretation in 2008 of federal lottery laws, any state conducting a lottery must have ownership of all but a "de minimis share of the equity interest" and must control all significant business decisions. As part of ownership and control, all states operating lotteries also exercise oversight, including auditing lottery operations.</p> <p><i>Risk Allocation for Michigan Lottery: Ownership, oversight and control of the Michigan Lottery are risks that must be managed by the public sector under current U.S. law regardless of the operating structure.</i></p>
<ul style="list-style-type: none"> ■ Monitoring 	<p>Monitoring includes requiring reports, audit rights, and other information to assess the performance of the lottery. It involves maintaining day-to-day management of lottery operations.</p> <p><i>Risk Allocation for Michigan Lottery: The responsibility for monitoring of the Michigan Lottery would vary depending on whether a lottery is state-run, operated by a public corporation or a private partner is engaged to operate the Lottery. In a public corporation structure, a board of directors typically monitors the lottery. If a private entity were to manage the lottery, the state lottery agency would become the monitor of the private operator.</i></p>
<ul style="list-style-type: none"> ■ Revenue ■ Operating Costs 	<p>Currently, some U.S. lotteries share revenue risk with their vendors, who are paid based on a percentage of gross revenue. However, all</p>

Risk Categories	Overview and Risk Allocation
	<p>U.S. lotteries retain the risk of operating costs and all but one retain net income risk. In contrast, many national European lotteries in countries such as the United Kingdom, Italy and Greece use net income as a key incentive to encourage the performance of their private lottery operators/managers. A recent U.S. example of this is the Illinois Lottery private management agreement, which includes a limited percentage of net income as part of the compensation package.</p> <p><i>Risk Allocation for Michigan Lottery: Net income risk and operating cost risk would be retained by the Michigan Lottery under a public corporation structure but could be shared to some degree under a private operating structure to provide stronger performance incentives.</i></p>
<ul style="list-style-type: none"> ■ Problem Gambling ■ Retailer Licensing 	<p>Problem gambling programs and retailer licensing are two functions intended to protect the public from the risks of gambling addiction and criminal or unreliable retailers and are generally considered core public sector functions.</p> <p><i>Risk Allocation for Michigan Lottery: Under all options assessed for the Michigan Lottery, these functions would be retained by the State.</i></p>
<ul style="list-style-type: none"> ■ Retailer recruitment/compensation ■ Appropriation/Budget ■ Human resources/Personnel ■ Procurement ■ Game innovation ■ Back office (technology, office space, etc.) ■ Technology (gaming system) ■ Advertising/Marketing ■ Printing ■ Distribution 	<p>To achieve a new operating structure, many of the operating risks and responsibilities currently retained by the State would be transferred to a public corporation or to a private manager. These responsibilities range from the ability to set the budget and spending plan for advertising, staffing and other functions, to the ability to contract and hire or fire independently of State procurement and personnel regulations.</p> <p><i>Risk Allocation for Michigan Lottery: Many of the key operating risks and responsibilities of the Michigan Lottery would be transferred to either a public corporation or to a private entity under a new operating structure.</i></p>

Public operating structure

Like many U.S. state lotteries, the Michigan Bureau of State Lottery is a division of a traditional public agency – the Department of Treasury – with significant service related contracting. The public corporation is the alternative to this operating structure that has been adopted by many of the more recently established state lotteries. A public corporation may provide the flexibility to operate more like a business and generate the enhanced profits for the state.

Public corporations are controlled by the states that established them, but they are independent entities that are self-supporting and establish their own procurement, personnel and other regulations. In Michigan, two parallel examples include the Michigan Economic Development Corporation and the Michigan State Housing Development Authority. Typically, a board of directors actively oversees the quasi-public lottery corporation while the state executive and legislature continues to provide a second level of oversight and monitoring. The board generally establishes policies for the state lottery, selects the chief executive officer and determines his/her compensation, and approves new games.

Under the public corporation operating structure for the Lottery, the State would retain ownership, oversight and control, and operating cost and revenue risk. The public corporation would take on the responsibility and risk of monitoring, problem gambling, retailer licensing and operations. Under this scenario, the State is able to transfer some risk to a public corporation and encourage entrepreneurial management of the Lottery while ensuring that the objectives of the public corporation align with the State's objectives.

In 2010, the Michigan Legislature considered a modernization proposal by the Lottery (introduced as House Bills 6336-6339 and 6341) which would have established a public corporation to operate the Lottery, similar to the Michigan Economic Development Corporation. This modernization proposal was intended to recognize that the Michigan Lottery is a business within state government, charged with generating revenue. The proposal aimed to put Michigan Lottery in line with the trend of some of the newest and most successful lotteries in the country, which operate under a public corporation structure.

Potential advantages/disadvantages of a public corporation

Potential advantages	Potential disadvantages
<ul style="list-style-type: none"> ■ State retains control over the lottery, especially over revenues and operating costs. ■ May encourage the Lottery to improve performance by becoming more entrepreneurial. ■ Gives the Lottery more operational flexibility including bidding its own contracts and determining the optimal level of advertising expenditures ■ Helps ensure the Lottery's objectives remain aligned with the state ■ Allows for market rate compensation to attract talent. ■ Allows competition for services currently provided by other government agencies, including back-office technology and real estate services. It is possible that the market rate for these services may be lower than the state's rates. 	<ul style="list-style-type: none"> ■ By maintaining full direct control, the state would continue to retain full revenue risk and would not have the option to share that risk or to require revenue growth guarantees as it might with a private entity. ■ Creating a public corporation would require legislation. ■ May not be necessary to achieve the flexibility for the lottery to function more like a business. ■ Potential efficiencies gained through operating allowances are subject to future legislative action.

Private operating structures

In recent years, a number of states have contemplated options to enter into private management agreements or public-private partnerships for their lotteries, through arrangements ranging from leasing the right to operate the lottery to a private entity to increasing the level of third party contractors operating lottery functions. States considered a variety of options around monetizing revenue streams, such as short-term and long-term leases with up-front payments or revenue sharing arrangements. By 2008, no states had yet entered into any of these private operating structures, due in part to a lack of clarity regarding the federal law that allows only states to conduct lotteries in the United States.

In October 2008, the U.S. Department of Justice (USDOJ), Office of Legal Counsel, issued a memo addressing the legal implications of these private operations and management options for state conducted lotteries. As discussed above, the USDOJ's memo concluded that states may contract with private firms for goods and services, including management services, for their lotteries, but states may not cede control over significant business decisions or equity interest in their lotteries (except for a de minimis amount). According to the USDOJ memo, the profit-sharing lottery operating structures common in Europe, such as the UK's arrangement with the private firm Camelot to be the operator of its national lottery, are not permissible in the United States. According to the USDOJ memo, "While the British government regulates the activities of Camelot, the private company retains a substantial portion of the profits of the enterprise and is authorized to make business decisions for the lottery without the approval of the British government."

The private management options for Michigan Lottery identified in this report are intended to be within the USDOJ memo's guidelines; however, the State should seek appropriate legal counsel on any such arrangement. As such, private management options that clearly transfer control and equity interest to a private manager, such as a long-term lease with a significant up-front payment, are not considered here. The two private options assessed below are variations on a private management agreement with control and equity interest retained by the state. These options consider whether the Michigan Lottery could gain the benefits of some risk transfer and of private sector efficiency and innovation within the guidelines of existing federal and state laws.

In addition to the USDOJ memo, the Michigan State Constitution (5 41 Lotteries) may impact private operating structures; however, again the State should seek appropriate legal counsel on any such arrangement. Section 41 may contribute to lower committed operating or profit commitments by a potential private manager to the State. Section 41 requires statewide and local referendums for any law authorizing a form of gambling in Michigan and for any new lottery game using table games or player operated mechanical or electronic devices. It is possible that firms may adjust their business plans based on their assessment of the legal implications of this provision on the private manager's ability to innovate.

Private operating structures: Option one

The first private option considered for the Michigan Lottery is a private management agreement with public control and de minimis revenue sharing. This agreement could be structured to have many similarities to the Illinois Lottery private management agreement with several variations that may provide additional benefit to the Michigan Lottery. Under this alternative, the Michigan Lottery would seek a private manager to take over day-to-day management of the lottery, and the Lottery's role would shift from operating to planning, coordinating and approving the private manager's activities. As with any private contractor to the State, the Lottery's private manager would be governed primarily by the terms of its contract with the Michigan Lottery. It is anticipated that the Michigan Legislature and the governor would continue to have ultimate oversight of the lottery.

If the objective of the Michigan Lottery and Legislature in entering a private management agreement is to maximize net income transferred to the state School Aid Fund, then the optimal private management agreement may wish to provide the manager with sufficient freedom and incentives to maximize profits and net income for the state. As a result, most operational risks and responsibilities would be transferred to the manager. Under this structure the manager would provide all equipment and services and perform all functions necessary to operate the Lottery for the State and may subcontract all or any of these functions (except management). The private manager would also set its own spending plan. The private manager would have full control over all personnel at will and determine staff size, responsibilities and compensation levels, including incentive pay. All new staff would be hired by the private manager. Current staff may be transferred to private manager via a plan established in the contract that provides current employees some level of assurance of future employment.

Based on the risk allocation reviewed in this report, and on the guidelines of the USDOJ opinion, Michigan would retain a number of key risks and responsibilities. Michigan would retain the authority to countermand or direct the manager's operating decisions and ownership of Lottery assets including intellectual property and ultimate ownership over technology contracts and other assets. The State would control the transfer of Lottery proceeds into the appropriate funds and manage and control the approval, suspension and issuance of Lottery retailer licenses.

The level of clarity and transparency in the private management agreement will be fundamental to its success. A concern that interviewees expressed regarding the Illinois private management agreement was that the contract potentially creates confusion and conflict by failing to provide sufficient specificity regarding roles and responsibilities. The roles and responsibilities of both the Michigan State Lottery Bureau and the private manager would be defined explicitly. In particular, the state would clarify its oversight and control role to specify when and how it may countermand a decision of the lottery manager.

The private manager would be selected based on defined criteria combined with a projection of revenue growth. The compensation for the private manager would be a yearly management fee plus reimbursement for all eligible operating expenses, similar to the Illinois Lottery. If the Michigan Lottery pursues this structure to incentivize performance, Michigan Lottery could consider providing incentive compensation tied to growth in net income. To ensure it remains within the USDOJ opinion's definition of de minimis, Michigan may choose to limit incentive payments to no more than 5% of net income, the amount selected as the limit in the Illinois agreement. Shortfall payments may also be required if the private manager fails to achieve a baseline established in the contract.

Private operating structures: Option two

The second private operating structure assessed for the Michigan Lottery would have the same characteristics as the first option, with two key areas of difference: compensation and monitoring. The second option for the Michigan Lottery would establish contract terms with a private manager that align the incentives of the state and the manager as closely as possible, within the USDOJ guidelines. The compensation option for this operating structure could be structured along the following lines:

- The private manager receives a percentage of gross revenue to cover operating expenses after prize winnings and retailer commissions. The percentage of gross revenue would be determined based on meeting net income targets, with a minimum percentage provided to cover basic expenses if net income targets are not met.
- In addition, the private manager receives a percentage of net income (up to 5%) as incentive payments for performance.
- The private manager may also provide a performance bond to the State as a form of up-front payment to guarantee its performance.

This compensation mechanism establishes a stronger performance incentive than annualized payments to cover expenses. It may also avoid conflicts arising from penalty payments based on guaranteed net income levels, as a private manager will likely dispute the cause of any shortfalls. Including a performance bond can enable the State to receive cash now for the Lottery without entering into a long term lease. The actual level of the performance bond would be negotiated as part of the private management agreement.

Along with stronger incentives, this private option would include a lower level of monitoring of the private manager by the State. While the State would continue to provide oversight of the private manager, the manager could operate without day-to-day involvement by the State.

Potential advantages/disadvantages of private operating options

Potential advantages	Potential disadvantages
<ul style="list-style-type: none"> ■ A private management agreement could make the lottery operations as close as possible to a business enterprise, within the guidelines of federal lottery laws. ■ Gaining any efficiencies and innovation inherent in a private sector management structure. ■ Tying the private manager's compensation to net income would help align the interests of the manager and the state. ■ Under a private management agreement, the State of Michigan would retain ultimate control and oversight and could continue to ensure that the Lottery is operated in a manner that maximizes net income while meeting other key public policy goals. 	<ul style="list-style-type: none"> ■ A private management agreement will initially increase the costs of operation for the Michigan Lottery, which would need to pay a manager's fee in addition to existing vendor and other operating costs. ■ Since the Michigan Lottery is a relatively mature lottery, with strong performance overall, it is unclear if the Michigan Lottery has the potential for material additional growth that would merit introducing a private manager. The peer analysis would suggest that the Michigan Lottery is already relatively efficiently run in accordance with best practice in many respects. ■ A private management agreement has the potential for conflict over terms and performance measures, and the success of the agreement may largely depend on how clearly and comprehensively it defines roles and responsibilities. ■ As long as compensation to the manager is based on performance standards and net income growth, there likely will be ongoing dialogue throughout the term of the contract regarding the cause and responsibility for any shortfall in performance or net income. ■ Section 41 may be prohibitive and/or contribute to lower committed operating or profit commitments.

Appendix I: USDOJ Opinion

United States Department of Justice Opinion

SCOPE OF EXEMPTION UNDER FEDERAL LOTTERY STATUTES

FOR LOTTERIES CONDUCTED BY A STATE

ACTING UNDER THE AUTHORITY OF STATE LAW

The statutory exemption for lotteries “conducted by a State” requires that the State exercise actual control over all significant business decisions made by the lottery enterprise and retain all but a de minimis share of the equity interest in the profits and losses of the business, as well as the rights to the trademarks and other unique intellectual property or essential assets of the State’s lottery.

It is permissible under the exemption for a State to contract with private firms to provide goods and services necessary to enable the State to conduct its lottery, including management services, as discussed in the opinion.

October 16, 2008

MEMORANDUM OPINION FOR THE ACTING ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION

Federal law generally prohibits the promotion and advertisement of lotteries in interstate commerce, 18 U.S.C. §§ 1301-1304, 1953(a) (2000 & West Supp. 2008), but exempts from these prohibitions, among other things, lotteries “conducted by [a] State acting under the authority of State law.” *Id.* §§ 1307(a)(1), 1307(b)(1), 1953(b)(4) (2000). We understand that a number of States have proposed to enter into contracts with private management companies for the long-term operation of their lotteries, pursuant to state legislation. Under the terms of these proposed arrangements, the private management company would operate the lottery business under standards established by the State, would make a fixed upfront or annual payment to the State representing a projection of profits from the lottery business, and would have some significant economic interest in the additional profits of the enterprise and would bear some significant portion of the risk of losses. The Criminal Division has asked us for guidance in determining whether a lottery operating under such a long-term private management arrangement would qualify as a lottery “conducted by a State acting under the authority of State law” within the meaning of the federal lottery statutes.

We conclude that the statutory exemption for lotteries “conducted by a State” requires that the State exercise actual control over all significant business decisions made by the lottery enterprise and retain all but a de minimis share of the equity interest in the profits and losses of the business, as well as the rights to the trademarks and other unique intellectual property or essential assets of the State’s lottery. It is permissible under the exemption for a State to contract with private firms to provide goods and services necessary to enable the State to conduct its lottery, including management services, as discussed herein.

I.

State-chartered lotteries were prevalent during the colonial period and the early years of the Republic. In the nineteenth century, public sentiment shifted against gambling, and by the end of the century most States had banned lotteries of any sort, public or private. The State of Louisiana, however, continued to permit the Louisiana Lottery Company, a powerful private entity, to operate under a monopoly from the State. Largely unregulated by Louisiana, the Louisiana Lottery Company made significant profits by promoting and selling tickets to the citizens of other States where lotteries were illegal. *See generally* National Institute of Law Enforcement and Criminal Justice, Law Enforcement Assistance Administration, United States Department of Justice, *The Development of the Law of Gambling 1776-1976* (1977) (“DOJ Gambling

Report"); G. Robert Blakey & Harold A. Kurland, *The Development of the Federal Law of Gambling*, 63 Cornell L. Rev. 923, 927-38 (1978).

To stop this circumvention of other States' laws and to address the perceived evils of the Louisiana Lottery Company, including the corruption of government officials and other problems associated with the commercialization of gambling, Congress in the 1890s made it a crime to sell or advertise lotteries through the mail or through interstate commerce. See Act of Sept. 19, 1890, ch. 908, § 1, 26 Stat. 465, *codified as amended at* 18 U.S.C. § 1302 (2000) (prohibiting the use of the mails for lottery-related purposes); Act of Mar. 2, 1895, ch. 191, § 1, 28 Stat. 963, *codified as amended at* 18 U.S.C. §§ 1301 (prohibiting interstate traffic in lottery materials), 1303 (prohibiting mail carriers from participating in lottery activities). Congress subsequently extended these prohibitions to broadcast media and to a broader array of gambling activity. See Communications Act of 1934, Pub. L. No. 73-416, § 316, 48 Stat. 1064, 1088-89, *codified as amended at* 18 U.S.C. § 1304 (prohibiting the broadcast of information concerning a lottery); Pub. L. No. 87-218, 75 Stat. 492 (1961) (amending Travel Act), *codified at* 18 U.S.C. § 1953(a) (prohibiting interstate transport of wagering paraphernalia). These prohibitions applied regardless of whether the lottery was run by a private entity or by a State. *United States v. Fabrizio*, 385 U.S. 263, 269 (1966).

Beginning with New Hampshire in 1963, a number of States decided to institute or reinstitute their own State-run lotteries to raise public funds. *DOJ Gambling Report at* 116-21; Blakey, *Federal Law of Gambling*, 63 Cornell L. Rev. at 950 & nn.114-15. By the end of 1974, thirteen States were conducting their own lotteries. H.R. Rep. No. 93-1517, at 4 (1974) (Committee on the Judiciary). To accommodate the promotion of these State-run lotteries, Congress in 1975 enacted exemptions to the criminal prohibitions in 18 U.S.C. §§ 1301-1304 and 1953(a) for "lotter[ies] conducted by [a] State acting under the authority of State law." Pub. L. No. 93-583, §§ 1, 3, 88 Stat. 1916 (the "1975 Act"), *codified as amended at* 18 U.S.C. §§ 1307(a)(1), 1307(b)(1), 1953(b)(4). An earlier version of the bill would have "permit[ted] the advertisement of any legal lottery, whether it is conducted by the State or not," but at the urging of the Department of Justice, it was rejected in committee in favor of the more restrictive limitation quoted above.⁹

In 1988, Congress added an exemption to section 1307 for lotteries that are "authorized or not otherwise prohibited by the State in which [they are] conducted," if those lotteries are "conducted by a not-for-profit organization or a governmental organization" or "conducted as a promotional activity by a commercial organization and [are] clearly occasional and ancillary to the primary business of that organization." Pub. L. No. 100-625, § 2(a), 102 Stat. 3205, *codified at* 18 U.S.C. § 1307(a)(2). Again, Congress gave serious consideration to legislation that would have "remove[d] federal restrictions on the advertising of legitimate lotteries and gambling activities in interstate commerce, whether conducted by public, private, or charitable interests," but declined to adopt such a broad exemption.¹⁰

Today, forty States, as well as the District of Columbia, operate government-run lotteries.¹¹ Although lotteries conducted by for-profit companies remain subject to the criminal prohibitions in 18 U.S.C. §§ 1301-1304 and

⁹ *State Conducted Lotteries: Hearing on H.R. 6668 and Companion Bills Before the Subcomm. on Claims and Governmental Relations of the H. Comm. on the Judiciary*, 93d Cong. 3 (1974) ("State Lottery Hearing"); see also H.R. Rep. No. 93-1517, at 8 (1974) (Committee on the Judiciary) ("When the subcommittee took favorable action on bill 6668 and reported it to the full committee it recommended a series of amendments which would have extended the exceptions in the bill to lotteries . . . authorized and licensed in accordance with State law." These amendments were rejected by the full committee, and are the amendments referred to in the statement of additional views appended to this report. The Justice Department opposed this series of amendments and, as has been noted, they were not accepted by the full committee and were not reported to the House.").

¹⁰ H.R. Rep. No. 100-557, at 3 (1988); see also *id.* at 9 (noting that the bill "would [have] permit[ted] the advertising of 'state-authorized' lotteries, and not merely 'state-conducted' lotteries") (quoting testimony of Douglas W. Kmiec, Deputy Assistant Attorney General, Office of Legal Counsel, Department of Justice); 131 Cong. Rec. 25,508 (1985) (statement of Rep. Frank) (introducing earlier version of bill that would have exempted any lottery "authorized and regulated by the State in which it is conducted").

¹¹ See *Ariz. Rev. Stat. Ann.* §§ 5-501 to 5-525 (2002 & Supp. 2007); *Cal. Gov't Code* § 8880 (2005 & West Supp. 2008); *Colo. Rev. Stat.* §§ 24-35-201 to 24-35-222 (2006); *Conn. Gen. Stat.* §§ 12-800 to 12-834 (2000 & West Supp. 2008); *Del. Code Ann.* tit. XXIX, §§ 4801-4824 (2003 & Supp. 2006); *D.C. Code* §§ 3-1301 to 3-1337 (2007 & Supp. 2008); *Fla. Stat. Ann.* §§ 24.101-24.124 (2003 & West Supp. 2008); *Ga. Code Ann.* §§ 50-27-1 to 50-27-55 (2006); *Idaho Code* §§ 67-7401 to 67-7452 (2006 & Supp. 2008); 20 *Ill. Comp. Stat. Ann.* §§ 1605/1-1605/27 (West 2008); *Ind. Code Ann.* §§ 4-30-1-1 to 4-30-19-4.2 (1996 & Lexis/Nexis Supp. 2008); *Iowa Code* § 99G (2004 & West 2008); *Kan. Stat. Ann.* §§ 74-8701 to 74-8721 (1992); *Ky. Rev. Stat. Ann.* §§ 154A.010-154A.990 (2006 & West 2007); *La. Rev. Stat. Ann.* §§ 47:9000-47:9081 (Supp. 2008); *Me. Rev. Stat. Ann.* tit. VIII, §§ 371-389 (1997 & Supp. 2007); *Md. Code Ann., State Gov't* §§ 9-101 to 9-125 (2004 & Lexis/Nexis Supp. 2007); *Mass. Ann. Laws* ch. 10, §§ 22-35, 36-40, 56-58 (2000 & Lexis/Nexis Supp. 2008); *Mich. Comp. Laws Ann.* §§ 432.1-432.47 (2001 & West Supp. 2008); *Minn. Stat. Ann.* §§ 349A.01-349A.16 (2004 & West Supp. 2008); *Mo. Rev. Stat.* §§ 313.200-313.353 (2001 & West Supp. 2008); *Mont. Code Ann.* §§ 23-7-103 to 23-7-412 (2007); *Neb. Rev. Stat. Ann.* §§ 9-801 to 9-841 (2003 & Lexis/Nexis Supp. 2007); *N.H. Rev. Stat. Ann.* §§ 284-21-a to 284-21-v (Lexis/Nexis Supp. 2007); *N.J. Stat. Ann.* §§ 5-9-1 to 5-9-25 (1996 & West Supp. 2008); *N.M. Stat. Ann.* §§ 6-24-1 to 6-24-34 (2008); *N.Y. Tax Law* §§ 1600-1620 (2004 & McKinney Supp. 2008); *N.C. Gen. Stat.* §§ 18C-101 to 18C-172 (2007); *N.D. Cent. Code* §§ 53-12.1-03 to 53-12.1-10 (2007 & Supp. 2007); *Ohio. Rev. Code Ann.* §§ 3770.01-3770.99 (2005 & Lexis/Nexis Supp. 2008); *Okla. Stat. Ann.* tit. 3A,

1953(a), some States are considering legislation that would authorize long-term agreements with private management companies to operate lotteries for the States, subject to prescribed standards, in return for a significant share of the profits of the lottery enterprise. The Criminal Division has sought our views on whether lotteries operated under such arrangements would fall within the scope of the federal exemption for lotteries “conducted by a State acting under the authority of State law.” The arrangements proposed by the States, as we understand them, would be authorized by state legislation, and the question comes down to whether lotteries so operated would be “conducted by” the States.¹²

II.

For the reasons set forth herein, we believe that the statutory exemption for lotteries “conducted by a State” requires that the State manage and direct the course of the lottery venture—by exercising actual control over all significant business decisions made by the enterprise—and that the State retain all but a de minimis share of the equity interest in the profits and losses of the business, as well as the rights to the trademarks and other unique intellectual property and assets essential to the State’s lottery. As we discuss more fully below, preserving the State’s ownership interests in the lottery business will help to ensure that the lottery will be operated by the State and solely for the public benefit of the State, which we believe the federal lottery statutes require. In our view, these requirements flow from the text and structure of the statutes, from their legislative history, and from relevant court decisions. In interpreting the scope of the exemption for lotteries “conducted by a State,” we find that principles of agency and partnership law are instructive by analogy.

A.

The verb “conduct” means “[t]o manage; direct; lead; have direction; carry on; regulate; do business.” Black’s Law Dictionary 295 (6th ed. 1990). See Webster’s Third New International Dictionary 474 (1993) (defining verb “conduct” to mean “lead,” “direct,” “control,” or “manage”); II Oxford English Dictionary 791 (1978) (similar). In the context of the federal lottery statutes, we believe the phrase “conducted by the State” contemplates that the State will “manage” the business, “direct” the affairs of the business, “carry on” its operations, and “do business” as a State-run enterprise, for the benefit of the State.

Although “regulate” is suggested in the dictionaries as one synonym for “conduct,” merely regulating the lottery, or licensing a private lottery concession pursuant to detailed standards prescribed by the State, plainly cannot be sufficient to satisfy the requirements of the statutory exemption. That the exemption requires more than state regulation or licensing is confirmed by 18 U.S.C. § 1307 as a whole. The exemption for lotteries “conducted by a State” in section 1307(a)(1) is followed immediately in section 1307(a)(2) by the exemption for a lottery “authorized or not otherwise prohibited by the State in which it is conducted” and “conducted by” a “not-for-profit organization,” a “governmental organization,” or “as a promotional activity by a commercial organization” that is clearly occasional and ancillary to the business of the organization. Were the phrase “conducted by a State” construed to include lotteries authorized, licensed, or regulated by the State (for example, pursuant to state law and subject to State-

§§ 701-735 (West Supp. 2008); Or. Rev. Stat. §§ 461.010 to 461.740 (2007); 72 Pa. Cons. Stat. §§ 3761-101 to 3761-314 (1995 & West 2008); R.I. Gen. Laws §§ 42-61-1 to 42-61-17 (2006); S.C. Code Ann. §§ 59-150-10 to 59-150-410 (2004 & Supp. 2007); S.D. Codified Laws §§ 42-7A-1 to 42-7A-65 (2004 & Supp. 2008); Tenn. Code Ann. §§ 4-51-101 to 4-51-206 (2005 & Supp. 2007); Tex. Gov’t Code Ann. §§ 466.001 to 466.453 (2004 & Vernon Supp. 2008); Vt. Stat. Ann. tit. XXXI, §§ 651-678 (2000 & Supp. 2007); Va. Stat. Ann. §§ 58.1-4000 to 58.1-4027 (2004 & Supp. 2007); Wash. Rev. Code Ann. §§ 67.70.010 to 67.70.905 (2001 & Lexis/Nexis 2008); W. Va. Code §§ 29-22-1 to 29-22-28 (2004 & Lexis/Nexis Supp. 2008); Wis. Stat. Ann. §§ 565.01 to 565.50 (West 2006).

¹² Such a lottery would not appear to qualify under any other exemption to the federal lottery statutes. The private management company contemplated in the various state proposals would not be a “not-for-profit organization” for purposes of the exemption enumerated in 18 U.S.C. § 1307(a)(2)(A); nor would the lottery be managed “as a promotional activity” that “is clearly occasional and ancillary to the primary business of that organization,” *id.* § 1307(a)(2)(B). Similarly, even if the private management company were to maintain a close working relationship with the state government, it would be highly unlikely to qualify as a “governmental organization” under section 1307(a)(2)(A). None of the remaining exemptions in sections 1307 and 1953(b) would have any conceivable application to a State-sponsored lottery. See 18 U.S.C. §§ 1307(b)(2), 1953(b)(1), (b)(3), (b)(5).

imposed standards), the exemption in section 1307(a)(1) would swallow those separately enumerated in section 1307(a)(2), a result that is strongly disfavored as a matter of statutory interpretation. See *Mackey v. Lanier Collection Agency & Serv., Inc.*, 486 U.S. 825, 837 & n.11 (1988) (“[W]e are hesitant to adopt an interpretation of a congressional enactment occasional promotional activities by commercial organizations strongly suggest that “conducted by” cannot mean “regulated by,” because not-for-profit organizations and commercial entities do not, in any conventional sense of the word, “regulate.”

The only federal decision to address the meaning of the statutory exemption for lotteries “conducted by a State” is consistent with this reading. In *United States v. Norberto*, 373 F. Supp. 2d 150 (E.D.N.Y. 2005), the court considered whether the exemption in section 1307(b)(2) for lotteries “authorized by the law[s] of [a] foreign country” requires that the foreign country affirmatively approve the conduct in question. See *id.* at 156. The defendants objected to such a reading on the ground that it would essentially read into that exemption a requirement (paralleling section 1307(a)(1)) that the lottery be “conducted by” the foreign government. The court rejected this contention, on the ground that a State’s affirmative authorization of an activity was not equivalent to its conducting that activity. To make this point, the court contrasted “the State of New York which has a state run lottery” with “the United Kingdom[, which] authorizes a private company known as ‘Camelot’ to be the government sanctioned operator of its National Lottery.” *Id.* at 156-57. Consistent with our conclusion here, the court indicated that the British arrangement—which the court understood to involve the use of a government-licensed and regulated management company to operate the lottery—would not qualify as a lottery conducted by a State. *Id.*¹³

The Rhode Island Supreme Court reached a similar conclusion in two advisory opinions addressing whether state lottery proposals were consistent with the Rhode Island Constitution’s prohibition on gaming except where “operated by the state.” R.I. Const. art. 6, § 15. The statutory proposals would have permitted a private gaming company and an Indian tribe to run a casino subject to close regulatory supervision by the State, and the court was asked to determine whether the proposed arrangements left the State with sufficient control to satisfy the requirements of the constitutional provision. Interpreting the word “operate” as we interpret “conduct” here (as entailing active control over the enterprise), the court held that the State must possess “the power to make decisions about all aspects of the functioning of [the] business enterprise.” *In re Advisory Opinion to House of Representatives*, 885 A.2d 698, 706 (R.I. 2005) (“*Casino II*”) (emphasis in original) (quoting *In re Advisory Opinion to Governor*, 856 A.2d 320, 331 (R.I. 2004) (“*Casino I*”). Thus, even though the state gaming commission would have had regulatory control over the casino under the proposal, and under one proposal would have had veto authority over certain decisions, the court found it disqualifying that “Harrah’s would make day-to-day decisions having to do with the functioning of the proposed casino while the Lottery Commission merely would enforce the applicable regulations.” *Casino I*, 856 A.2d at 331-32; see also *Casino II*, 885 A.2d at 707 (“Mere regulatory power over the most fundamental aspects of the gaming business—selection of the casino service provider—certainly falls short of ‘operating’ ‘all aspects’ of the facility.”).

This interpretation of “operate”—as necessarily including “the power to make decisions about all aspects of the functioning of [the] business enterprise”—is consistent with our interpretation of the verb “conduct” in sections 1307 and 1953(b). The court concluded that the State had to have “actual control,” which meant that it could not cede the power to “make day-to-day decisions having to do with the functioning of” the lottery. In addition, while ultimately concluding that the statutory proposal did not leave the State with sufficient authority to “operate” the lottery, the Rhode Island Supreme Court drew favorable attention to features of the proposal that “appear[ed] to vest operational control in the state.” *Casino II*, 885 A.2d at 708. These features included the right of the State “to direct daily revenue,” *id.* at 709; the responsibility of the gaming company to comply with detailed accounting procedures, *id.* at 709 & n.11; the right of the State to monitor all “gaming devices,” *id.* at 710; the right of the State to set the number of video lottery terminals and non-slot table games to be played at the casino, *id.*; the right of the State to set the odds of winning, *id.*; and “all other powers necessary and proper to fully and effectively execute and administer the provisions of this chapter for its purpose of allowing the state to operate a casino gaming facility,” *id.* at 711. Similarly here, a State’s authority over these aspects of lottery operations would be important in establishing that it is “conducting” the lottery and therefore that the lottery is eligible for section 1307(a)(1)’s statutory exemption.

¹³ It is significant to note that while the British government regulates the activities of Camelot, the private company retains a substantial portion of the profits of the enterprise and is authorized to make business decisions for the lottery without the approval of the British government. See <http://www.natlotcomm.gov.uk/UploadDocs/Contents/Documents/Final%20ITA-Full.pdf> (last visited Aug. 5, 2008).

There is a question whether the statutory exemption would allow for an arrangement in which the State's lottery is conducted jointly by the State and by a private for-profit management company—in effect, through a partnership or joint venture between the State and the private company. It might be suggested that even if the private company participates in the conduct of the business, by exercising significant control over some business decisions and participating significantly in the profits and risks of the venture, the lottery could still be “conducted by the State” as long as the State participates in the joint conduct of the lottery. We do not believe, however, that that is the better reading of the statutes.

The overall structure of the statutory scheme strongly suggests that to qualify for the exemption the lottery must be conducted by the State and only by the State, not jointly by the State and a private for-profit entity. Section 1307(a) sets forth several parallel exemptions for lotteries that are “conducted by a State,” “conducted by a not-for-profit organization or a governmental organization,” or “conducted as a promotional activity by a commercial organization” where the lottery is clearly only occasional and ancillary to the business of the commercial organization. 18 U.S.C. §§ 1307(a)(1), 1307(a)(2). These various options are stated disjunctively in the statute; the statute does not appear to allow for an option whereby a lottery might be conducted jointly by more than one of these entities at the same time (though admittedly the statute does not expressly foreclose that possibility). The very narrow scope of the exemption for “clearly occasional and ancillary” “promotional” lotteries conducted by “commercial organization[s]” underscores the evident objective of the federal lottery prohibitions to prevent the broader commercial promotion of lotteries that serve the profit-making interests of private companies, as opposed to the public interests of state and local governments and charitable organizations.

This conclusion is strongly reinforced by the legislative history of the lottery statutes. Although enacted in phases over time, marking the evolving nature of interstate commerce, the federal lottery statutes as a whole reflect a consistent and focused policy by Congress to prohibit private for-profit concerns from engaging in the promotion of lotteries and thereby to prevent recurrence of the perceived evils that were associated with the Louisiana Lottery Company. As explained by lawmakers at the time, the 1975 Act that created the exemption for State-conducted lotteries sought to accommodate the States’ renewed interest in using lotteries to generate state revenue for the benefit of the public interest¹⁴ while avoiding the risk of corruption and commercialization driven by private interests that Congress believed to be presented by privately operated lotteries, such as the Louisiana Lottery Company.¹⁵ Indeed, the House Committee on the Judiciary considered a version of the 1975 Act, passed out of a subcommittee, that would have exempted any lottery “authorized and licensed in accordance with state law.” H.R. Rep. No. 93-1517, at 8. A Department of Justice witness testified, however, that “the Department would not favor any change in the law which would have the effect of opening up the channels of commerce to individuals who would seize upon the existence of a State authorized lottery to ‘commercialize the process,’” and the Committee subsequently amended the bill to exempt only lotteries that were “conducted by a State.” *Id.* at 5-7 (quoting testimony of Deputy Attorney General Henry E. Petersen).

¹⁴ See S. Rep. No. 93-1404, at 8 (“It is the recommendation of the Committee that the Federal Government should not allow its laws to impede or prevent the lawfully authorized efforts of States to raise revenues and benefit its own citizens”); 120 Cong. Rec. 22,145 (1974) (statement of Sen. Kennedy) (“State lotteries . . . are not operating for private gain, but to supplement revenue in order to support essential public services.”); 120 Cong. Rec. 12,599 (1974) (statement of Rep. Rodino) (“I would like to point out that the revenue being derived from State authorized lotteries is being used for the purposes of education in many States. In some States it is being used to fund programs designed to serve the interests of the elderly.”); *id.* at 12,600 (statement of Rep. Cohen) (“Since there is no overriding Federal interest in prohibiting State controlled lotteries, the Federal Government should not interfere with the sovereignty of the individual States or in their selection of revenue-raising measures.”); *id.* at 12,604 (statement of Rep. Daniels) (“The lottery . . . is a painless means of raising much needed revenue”).

¹⁵ See 120 Cong. Rec. 12,601 (1974) (statement of Rep. Sarasin) (the 1890 anti-lottery acts were “intended to correct the abuses of a privately run illegal lottery,” not to prevent “the situation which exists today, where the States use lotteries to fund such worthwhile programs as education, environmental research, programs to aid the elderly, and for maintenance of open spaces and recreation areas”). See also *State Conducted Lotteries: Hearing on H.R. 6668 and Companion Bills Before the Subcomm. on Claims and Governmental Relations of the H. Comm. on the Judiciary*, 93d Cong. 29-30 (1974) (statement of William S. Lynch, Chief of the Organized Crime and Racketeering Section of the Criminal Division of the Department of Justice) (“[T]oday most State-operated lotteries are conducted by means of a central computer with information key-punched into its memory banks concerning every aspect of the lottery operation. This method prevents ticket alterations and duplications, improper claims, and thefts. It further operates to hinder organized criminal groups from infiltrating or stealing from these State lotteries.”); *quoted in* H.R. Rep. No. 93-1517, at 5-6; 120 Cong. Rec. 22,145 (1974) (statement of Sen. Kennedy) (“None of the abuses which existed in lotteries run for private profit a century ago are present in the lotteries of these States.”); 120 Cong. Rec. 12,600 (1974) (statement of Rep. McClory) (“Policing and disclosure policies have been built into the [Illinois lottery] system with the expectation of making impossible the kind of graft or corruption which existed in 19th century lottery systems.”); *id.* at 12,604 (statement of Rep. Daniels) (“Thirteen States now conduct State lotteries under the full protection of State law and regulation. During the several years of experience there have been none of the scandals that had been forecast and the lotteries have brought in millions of dollars in revenue for education and other needs.”).

In 1988, Congress again considered statutory language—this time, supported by the Justice Department—that would have “remove[d] federal restrictions on the advertising of legitimate lotteries and gambling activities in interstate commerce, whether conducted by public, private, or charitable interests.” H.R. Rep. 100-557, at 3 (1988); *see also id.* at 9 (noting that the bill “would [have] permit[ted] the advertising of ‘state-authorized’ lotteries, and not merely ‘state-conducted’ lotteries”) (quoting testimony of Douglas W. Kmiec, Deputy Assistant Attorney General, Office of Legal Counsel, Department of Justice); 131 Cong. Rec. 25,508 (1985) (statement of Rep. Frank) (introducing earlier version of bill that would have exempted any lottery “authorized and regulated by the State in which it is conducted”). Again, however, Congress rejected the proposal, and Members expressed concerns that private for-profit companies could not be trusted to operate lotteries in a publicly beneficial manner. *See, e.g.*, 134 Cong. Rec. 10,317-18, 11,261, 11,376 (1988) (statements of Rep. Wolf). Congress instead passed a version of the bill that gave exemptions to lotteries that were “authorized or not otherwise prohibited by the State in which [they are] conducted,” but only if those lotteries were “conducted by a not-for-profit organization or a governmental organization” or “as a promotional activity by a commercial organization.” Pub. L. No. 100-625, § 2(a), 102 Stat 3205, *codified at* 18 U.S.C. § 1307(a)(2).

We believe this history reflects a consistent legislative judgment against permitting private for-profit companies to conduct lotteries. It would appear to be inconsistent with this judgment to permit the injection of a private company’s profit-making interests into the conduct of the state lottery, because doing so would raise the risk that the lottery business would serve a private commercial motive, rather than serving solely the public interest of the State.

The law of partnership offers useful guidance, by analogy, on the sorts of arrangements with a private management company that would convert a lottery business “conducted by a State” into a joint enterprise between the State and the private entity. Perhaps most significantly, partnership law would suggest that a business becomes a partnership (as distinguished from a principal-agent relationship) when a single entity does not exercise actual control over all significant business decisions. Under the Uniform Partnership Act (“UPA”), which has been widely adopted and followed, “the power of ultimate control” is an essential element that “distinguishes a partnership from a mere agency relationship.” Uniform Partnership Act § 202 cmt. 1 (1997); *see also, e.g., Kidz Cloz, Inc. v. Officially For Kids, Inc.*, 320 F. Supp. 2d 164, 171 (S.D.N.Y. 2004) (under New York law, demonstrating “the parties’ joint control and management of the business” is necessary to prove the existence of a partnership); *Harbaugh v. Greslin*, 436 F. Supp. 2d 1315, 1321 (S.D. Fla. 2006) (same under Florida law). Similarly, mutual control is a hallmark of a joint venture. *See, e.g., Taylor v. Texaco, Inc.*, 510 F. Supp. 2d 1255, 1262 (N.D. Ga. 2007) (under Georgia law, “The element of mutual control is a crucial element of a joint venture”); Black’s Law Dictionary 843 (7th ed. 1999) (defining “each member’s equal voice in controlling the project” as a “necessary element” of a joint venture). These concepts closely mirror, in our view, the proper meaning of “conducted by a State,” consistent with the text and legislative history and purpose of the federal lottery statutes.

In our view, it is also relevant to note that the sharing of a significant interest in the profits and losses of the business is recognized as “characteristic of a partnership.” *Steelman v. Hirsch*, 473 F.3d 124, 130 (4th Cir. 2007); *see also, e.g., Mallis v. Bankers Trust Co.*, 717 F.2d 683, 690 (2d Cir.1983) (under New York law, “the crucial element of a joint venture is the existence of a mutual promise or undertaking of the parties to share in the profits . . . and submit to the burden of making good the losses”) (quotation marks omitted); *Thomas v. Price*, 718 F. Supp. 598, 605 (S.D. Tex. 1989) (under Texas law, “Major incidents of the partnership relationship are an agreement among the participants to share profits and losses and a mutual right of control to manage the partnership”); Black’s Law Dictionary at 843 (defining “shared profits and losses” as a “necessary element” of a joint venture). The UPA creates a rebuttable presumption that a person “who receives a share of the profits of a business” is a partner in the business. Uniform Partnership Act § 202(c)(3). Importantly, however, the presumption does not attach if the profits were received “in payment . . . for services as an independent contractor or of wages or other compensation to an employee.” *Id.* This result supports the notion that some de minimis portion of profits or revenues may be shared among the parties without creating a partnership, because de minimis profit-sharing is consistent with a principal-agent relationship, rather than a true partnership.¹⁶ We believe this concept is relevant in interpreting the exemption for lotteries “conducted by a State,” because the sharing of a significant interest in the profits and losses of the

¹⁶ *Cf. TIFD III-E, Inc. v. United States*, 459 F.3d 220, 233-35 (2d Cir. 2006) (holding that foreign banks’ investment in a partnership was properly classified as debt, not equity, for tax purposes where the banks had the contractual right to recoup their investment at an agreed upon rate of return plus an opportunity to participate in the profits of the partnership that was, as a practical matter, limited to 2.5% of the banks’ total investment—“a relatively insignificant incremental return over the projected eight-year life of the partnership”).

lottery enterprise would be expected to diminish significantly the State's incentive to exercise actual control over the management of the business and would mean also that the lottery would not be conducted solely in the public interest of the State, as Congress has mandated, but rather at least partially in the profit-maximizing interest of the private firm.¹⁷

For these reasons, we believe that an arrangement by which a State engages in the business of operating a lottery jointly with a private firm that shares substantially in the profits and risks of the enterprise would not be consistent with the statutory exemption. The concerns that apparently led Congress to prohibit private companies from conducting lotteries would still apply if a private company and a State were jointly to own and operate the lottery venture. See H.R. Rep. No. 93-1517, at 5-6; 120 Cong. Rec. 22,145 (1974) (statement of Sen. Kennedy) (warning against the abuses of "lotteries run for private profit" and stating the view that such abuses would not be present in State-conducted lotteries). We therefore believe that the exemption for lotteries "conducted by a State" requires that the lottery be "conducted by" the State alone, and not be conducted jointly by the State and by a private for-profit corporation, whether through a formal partnership or through some other form of joint business venture.

B.

Our conclusion that the State must exercise actual control over all significant business decisions of the lottery and retain all but a de minimis share of the equity interest does not mean that the State in conducting the lottery enterprise may not contract with private firms to provide goods and services necessary to the lottery. States that operate their own lotteries routinely contract with private businesses to print and sell lottery tickets, promote the lottery, insure against loss, consult about games, and perform a wide range of other functions as part of operating the lottery.¹⁸ We do not read the lottery statutes to foreclose these types of arrangements; that a State contracts with a private company to assist in certain functions associated with the lottery, even where the contractor is compensated for its services by a relatively small fixed percentage of the revenues of the lottery, does not mean that the State itself is no longer conducting the lottery. The private contractor in such circumstances—though providing valuable assistance to the State—is not "conducting" the lottery within the meaning of the statutes.

The delegation of management responsibilities to a private contractor presents a more difficult question. As discussed above, the verb "conduct" itself connotes management. Thus, unlike the delegation of other activities necessary to a lottery, such as promoting the lottery or printing tickets, an overbroad delegation of management responsibility would definitely call into question whether the State, and only the State, is exercising actual control over all significant business decisions of the lottery. For instance, simply imposing operating standards, even if freely amendable, would not be enough to give the State the necessary control over all significant business decisions of the lottery. Nor would a regulatory system of legal authorization and license alone be sufficient. Accordingly, we believe that there must be significant limits on the authority the State may delegate and still qualify for the exemption under section 1307(a)(1).

Principles of agency law are instructive in defining the appropriate line in judging a management services contract. To be said to "conduct" a lottery, the State must maintain and exercise control over all significant aspects of the

¹⁷ Although there may be no bright-line rule for identifying what would constitute a significant, or more than de minimis, ownership interest in the State's lottery business, examples of rules from other statutory and regulatory contexts may be useful by analogy. See, e.g., 15 U.S.C. § 78n(d)(1) (2006) (Williams Act provision requiring any person making tender offer for class of stock of publicly traded corporation to file disclosure report with SEC if, after consummation of offer, the person would own more than 5% of the class); H.R. Rep. No. 91-1655, at 3 (1970) (justifying Williams Act disclosure requirement on ground that "shareholders should be fully informed" of acquisitions of equity interests exceeding 5% because "[t]hese acquisitions may lead to important changes in the management or business of the company"); 26 C.F.R. § 1.368-2T(a)(2)(iii) & ex. 4 (2008) (IRS rule providing that "de minimis" variations in shareholder identity or proportionality of ownership are disregarded in determining whether transaction qualifies for tax treatment as "reorganization" under 26 U.S.C. § 368(a)(1)(D) (2000), and giving as example of such de minimis variation a 1% difference in stock ownership).

¹⁸ See, e.g., *Dalton v. Pataki*, 5 N.Y.3d 243, 271 (2005) ("The Division of the Lottery regularly contracts with outside vendors and other entities for various equipment and services to assist in the operation of the state lottery," under state constitutional provision prohibiting lotteries unless "operated by the state"); *State ex rel. Ohio Roundtable v. Taft*, No. 02AP-911, ¶ 32, 2003 WL 21470307, *6 (Ohio App. June 26, 2003) ("Ohio undisputedly contracts with various vendors for the operation and promotion of the lottery, whether for existing in-state games or the new multi-state Mega Millions," under state constitutional provision prohibiting lotteries unless "conduct[ed]" by "an agency of the state"); Mo. Rev. Stat. § 313.270 (2001) ("The director, pursuant to rules and regulations issued by the commission, may directly purchase or lease such goods or services as are necessary for effectuating the purposes of sections 313.200 to 313.350, including procurements which integrate functions such as lottery game design, supply of goods and services, and advertising."); Minn. Stat. § 349A.07(1) (2004) ("The director may enter into lottery procurement contracts for the purchase, lease, or lease-purchase of the goods or services.").

lottery operation. To the extent that such authority is delegated to a private management company, the management company should operate more in the role of an agent of the State, *see* Restatement (Third) of Agency § 1.01 (2006), than a partner that shares in the authority to make significant business decisions. This conclusion is fully consistent with the opinions of the Rhode Island Supreme Court in the *Casino I* and *Casino II* cases discussed above. In particular, a state official or agency must have the authority to direct or countermand operating decisions by the management company at any time. *Cf.* Restatement (Third) of Agency § 8.09, cmt. c (citing *id.* § 1.01, cmt. f(1)) (“The power to give interim instructions is an integral part of a principal’s control over an agent and a defining element in a relationship of common-law agency.”).¹⁹ The State need not always choose to exercise this authority if it is satisfied from its oversight that the management company is operating the lottery properly, but the existence of this authority is vital for the State to exercise actual control over the business—and to ensure that it has not shared such control with a private company.

For the same reason, we believe that to “conduct” the lottery through the agency of a management company, a State must maintain ready access to information regarding all lottery operations. To this end, as a necessary corollary of its authority over lottery operations, a State should have the right to demand and receive information from the management company concerning any aspect of the lottery operations at any time. *Cf.* Restatement (Third) of Agency § 8.12(3) (agent has duty “to keep and render accounts to the principal of money or other property received or paid out on the principal’s account”); La. Civ. Code art. 3003 (2005) (“At the request of the principal . . . the mandatary [agent] is bound to provide information and render an account of his performance of the mandate.”).

In addition, the management company must have the affirmative duty to provide the State with any information the company reasonably believes State officials would want to know to enable the State to conduct the lottery. *Cf.* Restatement (Third) of Agency § 8.11 (“An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when (1) subject to any manifestation by the principal, the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent’s duties to the principal; and (2) the facts can be provided to the principal without violating a superior duty owed by the agent to another person.”). These notifications will “enable[] the [State] to update and sharpen instructions provided to the [management company]” as the lottery operation evolves. *Id.* cmt. d. We conclude also that a management company must give the State advance notice of any operating decision that bears significantly on the public interest, such as decisions on the kinds of games to be offered to the public and decisions affecting the relative risk and reward of the games being offered, so that the State will have a reasonable opportunity to evaluate and countermand that decision. The affirmative duties to report material information, and to inform the State in advance of significant decisions, are critical to ensuring that the State’s legal authority to direct the actions of the lottery translates into actual, practical control over the lottery’s operations.

As for the ownership of assets, we do not foreclose the possibility that the State may, consistent with the limits of the exemption, permit the private management contractor to own and provide most of the assets needed for the lottery. Many such assets—computers, printing equipment, possibly the gaming equipment—are likely to be widely available for lease or purchase from other sources if the private company were to withdraw from the contract with the State. Thus, we do not think that a State’s contracting with a private management company to provide these assets for its lottery would necessarily put the lottery business under the effective control of the private contractor, so as to make the private company the State’s partner in conducting the lottery. Even some non-fungible assets—software, games, accounting systems—can be redeveloped or replaced, and therefore could also be leased by a State for use in its lottery without elevating the role of the company providing the assets to that of a partner or joint venturer in the lottery.

Other assets, such as the trade name and trademarks of the state lottery, may perhaps be truly essential to the State’s ownership and control of the lottery, in the sense that the State could not continue “conducting” its lottery (at least not without serious disruption) unless it retained ownership of these assets after discharging the management company. Ownership of these assets could be viewed as inextricably intertwined with the conduct of the lottery. Were a State to transfer such essential assets to a private company assisting the State in the

¹⁹ Unlike a principal at common law, which can contract away the right to direct its agents’ actions, *id.*, a State may not waive this responsibility, nor may it limit its authority to a veto power. *Cf. Casino II*, 885 A.2d at 706 (“[T]he power to choose is qualitatively different from the lesser power of vetoing another’s choice.”).

management of the lottery, the State could become so dependent upon the management company for the continued operation of the business as to call into significant question whether the State is actually conducting the lottery.

As we have discussed above, we believe that the ownership by the private management company of a significant equity interest in the profits of the lottery would go beyond the scope of the exemption. We understand that some States have proposed to enter into agreements with private management firms under which the private company would assist in the management of the lottery and receive a significant share of the lottery's profits or bear a significant share of the risk of losses. In return, it has been proposed that the management company would make a significant upfront payment to the State or make annual disbursements to the State. We believe that such an arrangement would not be consistent with the limited exemption for lotteries "conducted by a State." If a private management company were to oversee the lottery's operations and receive a significant share of the lottery's profits (particularly in return for an investment of capital), we think it clear that the company would not be a mere contractor or agent, assisting the State in operating a lottery that the State conducts, but rather a co-participant in the conduct of the lottery with substantial managerial responsibilities and a significant equity stake in the lottery's success or failure. In such circumstances, the private management company's incentives and ability to influence the lottery would be significant. Where a State has a reduced stake in the profits or losses of a lottery, its incentive to exercise the actual control over all significant business decisions required by the exemption is necessarily diminished. Indeed, in practical respects, an arrangement in which the State cedes to a private firm a significant economic interest in the profits and losses of the business may be functionally quite similar to an arrangement whereby the State licenses a lottery concession to a private company. As described above, these incentives and characteristics are precisely what Congress sought to avoid in enacting the exemption for lotteries "conducted by a State." *See supra* nn. 6-7 (contemplating that State-conducted lotteries would be operated for the public benefit).²⁰

That said, we think it is permissible for a State to compensate private contractors with some portion of the lottery's revenues or with some financial incentives that are contingent on the lottery's achievement of certain revenue objectives. For example, a State may agree to increase a private management company's fee by a certain amount if the lottery's revenues grow by a specified percentage in a given year. So long as the management company is not to receive more than a de minimis share of the lottery's profits, such an agreement would not significantly diminish the State's incentive to exercise actual control over the lottery.

Finally, it has been suggested that a private management company should be required to deposit lottery revenues into accounts owned by and maintained in the name of the State or state agency overseeing the lottery, and that the company be permitted to disburse funds from these accounts only on terms set forth in the management agreement. We believe that such accounting practices could be helpful in ensuring that the State, and not the private management company, is actually conducting the lottery business. Although we are not able to say that any particular accounting practice is mandated by the statutes, the more transparent the accounting

²⁰ *See also* Colo. Const. art. XVIII, § 2(7) ("Unless otherwise provided by statute, all proceeds from the lottery, after deduction of prizes and expenses, shall be allocated to the conservation trust fund of the state for distribution to municipalities and counties for park, recreation, and open space purposes."); Del. Const. art. II, § 17(a) ("All forms of gambling are prohibited in this State except . . . [l]otteries under State control for the purpose of raising funds"); Ga. Const. art. I, § 2, ¶ 8(c) ("Proceeds derived from the lottery or lotteries operated by or on behalf of the state shall be used to pay the operating expenses of the lottery or lotteries, including all prizes, without any appropriation required by law, and for educational programs and purposes as hereinafter provided."); La. Const. art. XI, § 6(A)(1) ("The net proceeds from the operation of the lottery shall be deposited in a special fund created in the state treasury entitled the Lottery Proceeds Fund."); N.H. Const. pt. 2, art. XI, § 25 ("[T]he legislative assembly shall authorize the state of North Dakota to join a multi-state lottery for the benefit of the state of North Dakota"); Mo. Const. art. III, § 39(b)(2), (3) ("The money received by the Missouri state lottery commission from the sale of Missouri lottery tickets, and from all other sources . . . shall be appropriated solely for public institutions of elementary, secondary and higher education."); N.H. Const. pt. 2, art. 6-b ("All moneys received from a state-run lottery and all the interest received on such moneys shall, after deducting the necessary costs of administration, be appropriated and used exclusively for the school districts of the state."); N.J. Const. art. IV, § 7, ¶ 2.C ("It shall be lawful for the Legislature to authorize the conduct of State lotteries restricted to the selling of rights to participate therein and the awarding of prizes by drawings when the entire net proceeds of any such lottery shall be for State institutions and State aid for education"); Tenn. Const. art. XI, § 5 ("[T]he legislature may authorize a state lottery if the net proceeds of the lottery's revenues are allocated to provide financial assistance to citizens of this state to enable such citizens to attend post-secondary educational institutions located within this state."); Va. Const. art. X, § 7-A ("Lottery proceeds shall be appropriated from the Fund to the Commonwealth's counties, cities and towns, and the school divisions thereof, to be expended for the purposes of public education."); Wis. Const. art. IV, § 24(6)(a) ("[N]et proceeds of the state lottery shall be deposited in the treasury of the state, to be used for property tax relief for residents of this state as provided by law.").

procedure,²¹ the more likely it will be that the State is in fact exercising active ownership and control over the enterprise.

III.

In sum, in order to satisfy the federal lottery statute exemption for lotteries “conducted by a State,” the State must exercise actual control over all significant business decisions made by the lottery enterprise and retain all but a de minimis share of the equity interest in the profits and losses of the business, as well as the rights to the trademarks and other unique intellectual property or essential assets of the State’s lottery. It is permissible under the exemption for a State to contract with private firms to provide goods and services necessary to enable the State to conduct its lottery, including management services, as discussed herein.

/s/

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Principal Deputy Assistant Attorney General

²¹ See, e.g., Cal. Gov’t Code § 8880.41 (“The director shall make and keep books and records that accurately and fairly reflect each day’s transactions, including, but not limited to, the distribution of tickets or shares to lottery game retailers, receipt of funds, prize claims, prize disbursements or prizes liable to be paid, expenses and other financial transactions of the lottery”); *id.* § 8880.42 (“The director shall provide a monthly cumulative sales report to the commission and the Controller within 15 days after the end of each month.”).

Appendix II: U.S. Lottery Rankings

U.S. Lotteries' FY10 Sales, Prizes & Government Transfers (\$M)						
Rank	Lottery	Population (M)	Traditional Sales*	VLT	Total Prizes**	Transfer to State
1	New York***	19.58	6,781.07	1,037.25	3,952.01	2,666.38
2	Florida	18.68	3,900.50		2,346.16	1,246.79
3	California	37.23	3,040.96		1,611.37	1,072.50
4	Texas	25.21	3,738.37		2,300.18	1,063.09
5	New Jersey	8.73	2,605.10		1,511.91	924.01
6	Pennsylvania	12.63	3,065.72		1,867.08	915.74
7	Massachusetts	6.63	4,412.09		3,174.89	903.48
8	Georgia	9.91	3,387.42		2,129.14	883.88
9	Ohio	11.53	2,490.19		1,513.72	728.63
10	Michigan	9.93	2,359.23		1,381.63	713.65
11	Illinois	12.94	2,191.42		1,313.66	651.73
12	West Virginia***	1.83	181.23	1,144.63	107.98	580.91
13	Oregon***	3.86	320.70	706.98	206.00	541.05
14	Maryland	5.74	1,706.57		1,034.16	510.61
15	North Carolina	9.46	1,421.33		835.30	433.21
16	Virginia	7.95	1,435.13		852.71	430.20
17	Rhode Island***	1.06	234.62	467.77	141.17	344.67
18	Delaware***	0.89	136.94	547.70	72.54	331.61
19	Tennessee	6.34	1,060.11		651.15	288.87
20	Connecticut	3.53	996.85		608.76	288.12
21	South Carolina	4.60	1,007.16		628.34	272.49
22	Missouri	6.01	971.86		628.06	259.67
23	Kentucky	4.34	723.43		421.91	214.25
24	Indiana	6.45	740.34		456.30	189.66
25	Washington	6.75	491.02		291.83	142.49
26	Arizona	6.68	551.49		333.11	141.86
27	Louisiana	4.53	372.39		189.75	133.70
28	Wisconsin	5.67	481.10		272.99	128.08
29	Minnesota	5.29	498.96		305.32	122.25
30	South Dakota***	0.82	45.54	215.46	25.52	119.78
31	Colorado	5.10	501.20		310.37	112.94
32	Arkansas	2.91	383.70		247.72	83.00
33	Oklahoma	3.72	199.75		105.09	70.47
34	Kansas	2.84	235.41		132.61	67.91
35	D.C.	0.61	230.16		118.93	66.75
36	New Hampshire	1.32	233.77		138.91	66.22
37	Iowa	3.02	256.26		150.45	57.91
38	Maine	1.31	217.03		133.44	52.87
39	New Mexico	2.03	143.59		78.61	43.61
40	Idaho	1.56	147.23		88.28	36.64
41	Nebraska	1.81	130.58		75.03	32.00
42	Vermont	0.62	97.48		61.12	21.58
43	Montana	0.98	46.85		25.94	10.53
44	North Dakota	0.65	24.42		12.64	5.72
Total		293.28	54,196.27	4,119.79	32,843.79	17,971.51

* This data represents only revenue from traditional lottery games

** Prizes do not include VLT prizes paid

*** Combined government revenues (profit) from traditional sales and VLT operations

Source: 19th Edition, La Fleur's 2011 World Lottery Almanac (The 2011 Almanac contains FY2010 data.. The 2012 Almanac was not available at the time of this report's development.)